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# Leverage, Linkage, and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Reform Debate

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# Leverage, Linkage, and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Reform Debate

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### I. Introduction

The argument for Social Security privatization is, at bottom, simple: we need more, and better, advance funding of the public retirement system.<sup>1</sup> In particular, we need to commit a portion of FICA tax to privately managed investment accounts, which will purchase investment instruments that promise higher rates of return than the government debt instruments in which the Social Security surplus is currently invested.<sup>2</sup> The privatization debate has centered on the extent to which Social Security faces an impending demographic crisis during the coming decades,<sup>3</sup> whether privatization is fundamentally inconsistent with the idea of social insurance,<sup>4</sup> whether privatization financial projections are accurate,<sup>5</sup> and whether privatization is a more rational means of securing and improving the financial status of retirees than the current Social Security system.<sup>6</sup>

The privatization debate, however, has been peculiarly divorced from the reality that this nation already has a massive retirement system in place in which the funding is almost entirely committed to private investment markets: the employment-based pension system. This employment-based pension system is sometimes referred to as the private pension system, although the adjective "private" is something of a misnomer. The federal government con-

1. See, e.g., Final Report of the President's Commission on Social Security (Dec. 21, 2001), available at [http://www.csss.gov/reports/Final\\_report.pdf](http://www.csss.gov/reports/Final_report.pdf) [hereinafter "Report"] (finding that existing Social Security system does not save for future and therefore future solvency depends on increased savings and investment at present); SOCIAL SECURITY, PROSPECTS FOR REAL REFORM 6-7 (Peter Ferrara ed., 1985) (arguing that Super IRAs can be used to expand current Social Security system); Thomas F. Siems, *Reengineering Social Security in the New Economy*, in 22 THE CATO PROJECT ON SOCIAL SECURITY PRIVATIZATION 2 (2001) (considering social security privatization as means to provide same retirement security in new economy as old economy under PAYGO system). The authors note that some proponents of a privatized Social Security system rest their position on ideological opposition to the idea of social insurance. The authors reject those arguments, which are in any event outside the scope of this Article.

2. See Report, *supra* note 1, at 11-13.

3. Compare Report, *supra* note 1, at 4, with Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. REV. 975, 987-96 (2000) (critiquing demographic crisis rationale for privatization of Social Security).

4. See, e.g., Dilley, *supra* note 3, at 975; see also LAURENCE S. SEIDMAN, FUNDING SOCIAL SECURITY 117-22 (1999) (noting that advocates of privatization reject concept of Social Security as wage-related, as earned-right, as redistributive, and as inflation-protected).

5. See, e.g., ROBERT EISNER, SOCIAL SECURITY: MORE NOT LESS 5-9 (1998); see also Paul Krugman, Editorial, *Fabricating a Crisis*, N.Y. TIMES, Aug. 21, 2001, at A17 ("Last week the International Monetary Fund, which has no political stake in the debate over Social Security, told the prosaic truth: 'the long-term financing problems of Social Security are not large' and 'could be addressed through relatively small adjustments in the program's parameters.'").

6. See, e.g., CHRISTIAN E. WELLER, UNDERMINING SOCIAL SECURITY WITH PRIVATE ACCOUNTS (Econ. Policy Inst. Issue Brief No. 172, Dec. 11, 2001), at <http://www.epinet.org/Issuebriefs/ib172/ib172.pdf>. See generally EISNER, *supra* note 5; SEIDMAN, *supra* note 4.

tributes mightily to the system through tax subsidies,<sup>7</sup> and many employment-based pension plans are maintained by public entities for their employees rather than by private-sector employers.<sup>8</sup> We nevertheless use the term "private pension system" here, in large part because we focus on concerns with private sector retirement plans.

We attempt in this Article to advance the debate over whether to privatize Social Security by reflecting on three of the private pension system's major problems and their relevance in the Social Security reform debate. We refer to these issues as ones of leverage, linkage, and leakage.

By leverage, we refer to the widely accepted idea that the private pension system is intended to encourage employers to set up plans to create retirement security for those of their employees who would otherwise not save adequately for their years outside the labor market.<sup>9</sup> The government accomplishes this goal by providing tax incentives for business owners and managers to establish plans for themselves and then by leveraging these incentives through regulations that require the plans also to provide benefits for low and moderate-income employees.<sup>10</sup> By linkage, we refer to the idea that there should be a close identity between the retirement benefits employees reasonably expect to receive under their retirement plan and what they actually receive.<sup>11</sup> By leakage, we refer to the idea that pension plans are intended to

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7. The Joint Committee on Taxation estimates that the tax expenditure for employer-based retirement plans in the 2001 fiscal year will be approximately \$100 billion. See JOINT COMM. ON TAXATION, ESTIMATE OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2001-2005 (JCS-1) 2 (Apr. 6, 2001) (reporting estimates for tax expenditures based on provisions of tax code as enacted through December 31, 2001).

8. For example, the California Public Employees Retirement System ("CalPERS") covers 1.2 million workers and retirees and has over \$20 billion in annual revenues. See CalPERS, *About CalPERS, Facts at a Glance*, at <http://www.calpers.ca.gov/about/factgla/factgla.htm> (last modified Nov. 30, 2001) (providing background information and statistical data for state-sponsored benefit retirement plan). The Federal Thrift Savings Plan for federal employees had approximately \$93 billion in assets as of December 31, 2000. Financial Statements of the Thrift Savings Fund, 1999 and 2000 (Mar. 14, 2001), at 3, available at <http://www.frtib.gov/FOIA/TSP-2001-financial-stmt.pdf> (providing general information regarding retirement savings and investment plan for federal employees).

9. See generally Daniel I. Halperin, *Tax Policy and Retirement Income: A Rational Model for the 21st Century*, in SEARCH FOR A NATIONAL RETIREMENT INCOME POLICY 159 (Jack L. VanDerhei ed., 1987).

10. See Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 420 (1984) (exploring congressional grant of substantial tax advantages to qualified retirement plans designed to ensure that retirement plans flow to lower-paid employees).

11. This was, in fact, a major congressional purpose in enacting ERISA. See, e.g., SENATE COMM. ON LABOR & PUB. WELFARE, S. REP. NO. 93-127, at 5, 8 (1973); 119 CONG. REC. 130 (Jan. 4, 1973) ("Our study shows that private pension plans repeatedly fail to fulfill their promise of retirement security. The subcommittee provided a public forum, for the first

provide retirement income, and, therefore, plan assets should not leak out of the plan for non-retirement purposes.<sup>12</sup> The private pension system, in our view, has inadequate leverage and linkage and an alarming degree of leakage.

Reflecting on these problems of the private pension system can inform the Social Security reform debate in two significant ways. First, to the extent that Social Security and the private pension system are understood as two components of a unified national retirement policy, they should work in complementary fashion to produce a coherent policy result that addresses the income security needs of all, or almost all, of the nation's nonworking-aged population. From this perspective, Social Security should backstop the weaknesses of the private system and satisfy objectives it does not adequately address. Second, the private system is a funded system similar in some ways to proposed privatization models and may hold some lessons for how a privatized system should be designed, if one is to be designed at all. Our own view, though, is that no design features can adequately harmonize individual investment accounts with the concept of social insurance.<sup>13</sup> We leave the second question to those either less committed than we to the idea of social insurance or less skeptical about the compatibility of that idea with a Social Security system based on private investment accounts.

Parts II, III, and IV discuss the problems of leverage, linkage, and leakage in the private sector pension system. Part V explores the meaning of these problems in the private pension system for the Social Security reform debate.

## II. *The Problem of Leverage*

Every year since 1972, the Joint Committee on Taxation has prepared a tax expenditure budget, an estimate of the year's lost tax revenue resulting

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time, for workers who have suffered because of such failures, and we listened to one heartbreaking story after another of dashed hopes, broken promises, and the bleak despair of a poverty-stricken old age . . . workers eloquently expressed the shock and despair they felt when they learned that their dreams of living out retirement years in economic security were never going to come true." (comments of Sen. Williams)); HOUSE COMM. ON WAYS AND MEANS, PRIVATE PENSION TAX REFORM, H.R. REP. NO. 93-779, at 2, 8 (1974); 120 CONG. REC. 4277 (Feb. 26, 1974) ("Too many people pay money into private pension plans year after year expecting eventually to receive retirement income, and they end up getting nothing." (comments of Rep. Perkins)); *id.* at 4319 ("Our hardest working citizens forego higher salaries in the expectation of receiving promised pensions. . . . Yet I know that I am not alone in testifying to the number of letters constituents have sent me, detailing 'horror stories' of unfulfilled pension promises." (comments of Rep. Holtzman)).

12. See ADVISORY COUNCIL ON EMPLOYEE WELFARE & PENSION BENEFITS, U.S. DEP'T OF LABOR, REPORT OF THE WORKING GROUP ON RETIREMENT PLAN LEAKAGE: "ARE WE CASHING OUT OUR FUTURE?" (Nov. 13, 1998) [hereinafter CASHING OUT OUR FUTURE?], available at <http://www.dol.gov/dol/pwba/public/adcoun/leaknew1.htm> (discussing leakage problem).

13. See generally Dille, *supra* note 3.

from those provisions in the Internal Revenue Code that depart from the ordinary structure of an income tax.<sup>14</sup> Among the provisions considered to produce tax expenditures are those that govern the tax treatment of "qualified" employer pension plans.<sup>15</sup> The Congressional Budget Office estimates the lost tax revenue related to public and private pensions to be more than \$90 billion dollars and more than \$100 billion if we include individual retirement accounts.<sup>16</sup> This is a sizable sum; in fact, it is the largest of all the expenditures in the tax expenditure budget.<sup>17</sup>

Some have challenged the notion of a tax expenditure budget,<sup>18</sup> although not necessarily the idea that certain tax provisions depart from the structure of an ideal income tax or create a tax subsidy for certain types of activities.<sup>19</sup> Others have argued that the tax treatment of "qualified" pension plans does not involve tax expenditures or tax subsidies at all.<sup>20</sup> For the purposes of this

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14. See JOINT COMM. ON TAXATION, *supra* note 7, at 2.

15. *Id.* at 4. Under a normative definition of income, contributions to a pension funding vehicle and the earnings of the funding vehicle would be immediately taxable. In contrast, the Internal Revenue Code provides for deferral of such income until distributed to participants as benefits. I.R.C. § 402 (1994) (generally deferring taxation of participants until distribution of benefits); I.R.C. § 501(a) (1994) (providing tax-exempt status for plan's funding vehicle).

16. *Id.* at 22. The breakdown is \$85 billion for employer plans; \$5.5 for Keogh plans, which are plans maintained by self-employed individuals for themselves and their employees; and \$10.3 billion for individual retirement accounts. This latter figure includes the earnings on individual retirement accounts, some of which are accounts to which individuals have "rolled over" distributions from employer plans. See I.R.C. § 404(e) (1994) (detailing rules permitting taxpayers to roll over distributions from employer plans to individual retirement accounts).

17. See JOINT COMM. ON TAXATION, *supra* note 7, at 21. The second-largest tax expenditure is \$66.1 billion relating to the exclusion for employer-provided health care and insurance premiums. *Id.*

18. Professor Boris Bittker wrote the classic argument against the creation of a tax expenditure budget. See generally Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969). For a response to Professor Bittker, see Stanley S. Surrey & William F. Helmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969). For a remarkably prescient 1937 view of tax subsidy as the equivalent to direct governmental spending, see Lawrence R. Bloomenthal, *Tax Exemptions*, 15 TAXES, THE TAX MAG. 269 (1937), which observed that "[a] tax exemption invariably acts as a subsidy to the individuals benefitted thereby. The idea may seem somewhat farfetched at first, but upon further consideration, it becomes apparent that a subsidy can arise in other ways than by a direct grant of money from the public treasury. . . . There is no difference in practical effect between a cash benefit payment and an exemption from taxes levied on all others who are not in the same class as those exempted." *Id.*

19. See generally Bittker, *supra* note 18.

20. See, e.g., Robert R. Fric & James G. Archer, *Taxation and Regulation of Pension Plans Under the Internal Revenue Code*, 1967 U. ILL. L.F. 691, 692 (1967) (explaining advantages of qualified employee retirement plans); Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315, 316 (1988) (arguing that because qualified plans are not tax expenditures, they do not violate normal tax procedures).

Article, we accept the conventional understanding that the Internal Revenue Code does provide a valuable tax subsidy for qualified pension plans and that the subsidy should be justified by some purpose extrinsic to the goals of an income tax.

The orthodox explanation for the subsidy is that it provides retirement income security for employees who would not otherwise save adequately for retirement.<sup>21</sup> The intended primary beneficiaries of the tax expenditure, then, are low- and moderate-income employees, who often find it difficult to save on their own for retirement because of immediate consumption demands.<sup>22</sup> More affluent individuals have greater capacity to save for their retirement without governmental assistance.

Given that the intended primary beneficiaries of the subsidy are low- and moderate-income workers, the structure of the Internal Revenue Code's subsidy of retirement plans might strike one as irrational, for its architecture allows unreconstructed tax deferral for plan participants. The value of the tax deferral to a given taxpayer directly correlates to that taxpayer's marginal tax rate. Thus, the Code provides the greatest retirement tax subsidy to the people with the greatest capacity to save for their own retirement and the smallest to those with the smallest capacity. Understood another way, this upside-down tax subsidy is an arguably rational component of a two-part governmental strategy to enlist the private sector in building retirement savings for low- and moderate-income workers.<sup>23</sup>

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*But see* Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225, 226-27 (1991) (arguing that regimes can be designed to satisfy Zelinsky's tax principles without subsidizing retirement savings); Edward A. Zelinsky, *Qualified Plans and Identifying Tax Expenditure: A Rejoinder to Professor Stein*, 9 AM. J. TAX POL'Y 257, 258-59 (1991) (arguing that qualified plans should not be regarded as generating tax expenditures because they satisfy normative tax principles at least as well as alternative models for taxing qualified plans).

21. See Norman P. Stein, *Of Carrots and Sticks: The Paring Down of the Qualified-Plan Paradigm*, in 1999 A.L.L.-A.B.A. PENSION POLICY CONFERENCE: ERISA AFTER 25 YEARS 193, 195; see also H.R. REP. NO. 99-313, at 578 (1985) ("For many years, the [Senate Finance Committee] has supported measures that provide tax incentives designed to encourage employers to provide retirement benefits for rank-and-file employees. It has been the committee's intention that these tax incentives, which are more valuable for individuals with high levels of income because of their marginal tax rates, should be available to employers only if their plans provide benefits for rank-and-file employees."); DAN M. MCGILL ET AL., *FUNDAMENTALS OF PRIVATE PENSIONS* 75 (7th ed. 1996) (explaining that nondiscrimination plans prohibit plan benefits or contributions from favoring highly compensated employees).

22. See Halperin, *supra* note 9, at 164 (noting that tax benefits "are appropriate, if at all, only for employer-sponsored plans which *actually* provide significant retirement income for low- and moderate-income employees").

23. See generally Michael A. Oberst, *A Perspective on the Qualified Plan Tax Subsidy*, 32 BUFF. L. REV. 603 (1983); Wolk, *supra* note 10.

This strategy is first to make the tax benefits of qualified plans sufficiently attractive to the tax-sensitive people who own and manage businesses so that they decide to set up plans to capture tax benefits for themselves; and second to require such plans, once established, to provide meaningful benefits not only to the people who set them up but also to their low- and moderate-income employees.<sup>24</sup> The Code effects the latter part of the strategy through a series of statutory provisions, most prominently the nondiscrimination rules.<sup>25</sup> Professor Dan Halperin has used a (tax) carrot and (regulatory) stick metaphor to describe the strategy.<sup>26</sup> Some have called this trickle-down benefits policy.<sup>27</sup> This is, in any event, the idea that we refer to here as leverage. As the pension economist Alicia Munnell put it, "The rationale for favorable tax treatment of qualified plans is that retirement benefits for rank-and-file employees will exist if Congress provides tax incentives that induce higher paid employees to support the establishment of employer-sponsored pension plans."<sup>28</sup>

The tax treatment of qualified plans has been subject to criticism, and indeed, its rationale is only arguably rational.<sup>29</sup> Firms do respond to the tax incentives by establishing plans. But firms often do not want to cover low-

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24. See Wolk, *supra* note 10, at 434 (examining discrimination rules that have proven inefficient in preventing employers from structuring plans to favor highly compensated employees).

25. See I.R.C. § 401(a)(4) (1994) (stating rules governing non-discrimination of highly paid employees); I.R.C. § 410(b) (1994) (allowing for exclusion of certain employees, non-residents, and those covered by other provisions); see also Treas. Reg. § 1.401(a)-4 (1994) (explaining how I.R.C. § 401(a)(4) applies to optional forms of benefit); Treas. Reg. § 1.410(b) (1994) (explaining minimum coverage requirements of I.R.C. § 410(b)).

26. See Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX L. REV. 1, 7 (1993) (arguing that while government subsidies have been cut, this should not lead to complacency about future success of private retirement system); see also Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063, 1141 (1997) (noting that "the carrot is the tax benefit of establishing a qualified pension plan and the stick is the limit on that benefit imposed by the non-discrimination rules"); Stein, *supra* note 21, at 195 (citing Halperin's use of carrot and stick metaphor).

27. See Stein, *supra* note 21, at 195 (citing "trickle-down benefits policy" as label for strategy).

28. ALICIA H. MUNNELL, *THE ECONOMICS OF PRIVATE PENSIONS* 51 (The Brookings Inst. 1982).

29. See, e.g., Halperin, *supra* note 9, at 160 (stating that special tax treatment of qualified plans is designed to encourage retirement savings but does not always meet that goal in practice); Oberst, *supra* note 23, at 618-28 (arguing that analysis of contribution and benefit limits casts doubts as to whether current qualified plan regime is worth maintaining); Wolk, *supra* note 10, at 421 (demonstrating that although tax subsidy component of qualified plans have met with general approval, critics have argued that advantages of such plans are not subsidies at all).



and moderate-income employees because those employees, at least as a group, do not value deferred compensation at its cost to the firm.<sup>30</sup> Accordingly, some employers who participate in the system play a game of statutory limbo, bending under the regulatory stick by manipulating the complexities of the nondiscrimination rules to minimize or eliminate benefits for rank-and-file employees, while maximizing benefits for the highly compensated.<sup>31</sup> Moreover, many employers simply do not respond to the incentives and fail to sponsor pension plans.<sup>32</sup> Thus, the system is both overinclusive in that it provides benefits for those who can save for their own retirement absent governmental incentive, and underinclusive because it fails to cover many low- and moderate-income workers at all and pays only minimum benefits to some of the covered low- and moderate-income employees.

Despite these criticisms, the basic paradigm – tax benefits to encourage plans and nondiscrimination rules to ensure that the plans provide meaningful benefits to regular employees – has endured as the rationale for the favored tax treatment of qualified plans. Furthermore, qualified plan coverage of the private workforce has remained pretty much steady at around 50%.<sup>33</sup>

There are, of course, different ways of measuring coverage, depending on how the workforce itself is defined. For example, the coverage rate is only about 42% if all workers, regardless of age, are included.<sup>34</sup> The rate increases to 50% if the relevant workforce excludes those under age twenty-five and increases to 58% if it is limited to full-time workers over age twenty-five.<sup>35</sup>

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30. See, e.g., Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790, 806 (1988) (examining argument that anti-discriminatory tax provisions generally reduce amount of cash compensation and perceived value of compensation package to rank-and-file employees); Halperin, *supra* note 9, at 192 (noting possibility that low- and moderate-income employees may not value pensions as much as current wages); Wolk, *supra* note 10, at 430-31 (arguing that enhanced return on savings generated by subsidies may not be enough to sway low-income employees from their preference for immediate compensation).

31. See Wolk, *supra* note 10, at 432 (arguing that under qualified plan regimes, employers favor covering highly-compensated employees because employees are likely to value such coverage and would be willing to substitute it for immediate compensation).

32. The failure to sponsor plans is primarily a small employer phenomena. Firms without pension plans cover approximately seventy-five percent of all employees working for small firms – those with fewer than 100 employees. An EBRI annual survey shows that the primary reasons that small firms fail to sponsor plans are that their workers would rather be paid cash wages and that business revenue is too uncertain. EMPLOYEE BENEFIT RESEARCH INST., SMALL EMPLOYER RETIREMENT SURVEY 2001 (2001) [hereinafter EBRI SURVEY].

33. See Alicia H. Munnell & Annika Sunden, *Private Pensions: Coverage and Benefit Trends 1* (Pension Rights Ctr. Conversation on Coverage, 2001), available at <http://www.ourfuture.org/articles/20010927082824.pdf>; see also *id.* at 35 fig. 1.

34. *Id.*

35. *Id.*

Not surprisingly, the coverage rates decline with income: the coverage rate for the top quintile by earnings approaches 76%, drops to approximately 68% for the second quintile, 58% for the third quintile, 40% for the fourth quintile, and 18% for the lowest quintile.<sup>36</sup>

There are two explanations for low coverage rates: some employees work for firms that do not sponsor a plan, and some employees do not participate in plans sponsored by their firms. There are three reasons for the latter explanation: (1) regulations permitting firms to exclude employees with certain characteristics (for example, part-time employees, employees covered by collective bargaining agreements, employees with less than a year of service, and employees younger than age twenty-one);<sup>37</sup> (2) regulations permitting firms to develop additional criteria for plan coverage;<sup>38</sup> and (3) regulations permitting firms to establish plans – primarily 401(k) plans – under which employees must elect to receive reduced current wages in order to participate.<sup>39</sup>

Coverage statistics do not, of course, tell the entire story about private sector pension benefits flowing to low- and moderate-income workers, for they show only whether an employee, at any given moment, is currently participating in a plan. The Internal Revenue Code permits firms to sponsor plans that provide lower levels of benefits for low- and moderate-income workers than for other employees.<sup>40</sup> Low- and moderate-income employees, as a group, defer a smaller percentage of their compensation to 401(k) plans than more affluent employees.<sup>41</sup> Firms are permitted to include forfeiture provisions in

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36. *Id.* at 36 fig. 2. The statistics reflect rates for non-Hispanic whites, but the coverage drops are similar for non-Hispanic black and Hispanic populations.

37. *See* I.R.C. § 410(b)(4) (1994) (establishing exclusionary rules of age and service requirements).

38. I.R.C. § 410(b) establishes minimum participation standards for plans. A plan satisfies those rules if it satisfies either an exclusively mathematical test, I.R.C. § 410(b)(1), or a more flexible but complex test that is primarily but not exclusively mathematical, I.R.C. § 410(b)(2). The latter test also requires that any classification system used to determine plan eligibility is "reasonable and established under objective business criteria that identify the category of employee eligible to participate under the plan." *Treas. Reg.* § 1.410(b)-4(b) (1994).

39. *See* I.R.C. § 401(k) (1994) (establishing rule for cash and profit-sharing plan); I.R.C. § 401(m) (1994) (stating non-discrimination test for matching contributions); I.R.C. § 402(g) (1994) (placing limitation on exclusion for elective deferrals); I.R.C. § 403(b) (1994) (defining taxability of beneficiary).

40. *See* I.R.C. § 401(l) (1994) (providing for integration of plans with Social Security); *Treas. Reg.* § 1.401(a)(4)-8 (1994) (providing levels of permitted disparity for plans that do not integrate with Social Security in form); Norman Stein & Peter Orszag, *Cross-Tested Defined Contribution Plans: A Response to Professor Zelinsky*, 49 *BUFF. L. REV.* 629, 630 (2001) (discussing degree of permissible discrimination possible in cross-tested defined contribution plans).

41. *See* James M. Porterba et al., *Informing Retirement-Security Reform, 401(k) Plans and Future Patterns of Retirement Saving*, 88 *AM. ECON. REV.* 179, 181 (May 1998) (charting participation in and eligibility for 401(k) plans).

their plans for employees who have not worked at least five years.<sup>42</sup> Because average job tenures decline with income level, such forfeiture provisions may disproportionately affect low- and moderate-income workers.<sup>43</sup>

According to one extrapolation of 1998 Social Security data, private sector pension plan benefits provide 29.8% of the retirement income for the top quintile of income of the population above age 55; 28.1% for the second quintile; 16.1% for the third quintile; 6.8% for the fourth quintile; and 3.3% for the fifth quintile.<sup>44</sup>

Thus, there are two issues that subvert the rationale for subsidizing qualified plans: low- and moderate-income employees have low rates of coverage *and* they earn relatively low levels of benefits when they are covered. The two issues might be viewed collectively as one of low effective coverage, i.e., coverage that results in meaningful levels of benefits for low- and moderate-income workers.

In the 1980s, Congress began a process of amending the Internal Revenue Code to improve effective coverage by adopting new regulatory measures designed to increase (1) the coverage rates of plans when firms choose to sponsor them<sup>45</sup> and (2) the benefit accruals of those low- and moderate-income plan participants.<sup>46</sup> To increase coverage rates in plans, Congress tightened the statutory rules that mandate a minimum degree of coverage<sup>47</sup> and

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42. See I.R.C. § 411(a)(2)(A) (1994). The forfeiture conditions apply only to employer contributions; employee contributions, whether or not elective, are immediately vested. I.R.C. § 411(a)(1) (1994). Congress amended the Internal Revenue Code in 2001 to provide that employer matching contributions must vest within three years. I.R.C. § 411(a)(12)(A) (1994).

43. See JOHN A. TURNER, PENSION POLICY FOR A MOBILE LABOR FORCE 30 tbl.3.6 (1993). It should be noted that younger workers may often be lower-paid and as a group tend to have more kinetic employment patterns than older employees. *Id.* at 22-23 tbl.3.3. To some extent, then, the higher turnover rates for low-income individuals may be attributable to age rather than income.

44. Munnell & Sunden, *supra* note 33, at 53 tbl.7.

45. See *infra* notes 47-48 and accompanying text.

46. See *infra* notes 49-52 and accompanying text.

47. Prior to 1986, a plan could satisfy the minimum coverage requirements of the Internal Revenue Code by covering 70% of all employees or 80% of the eligible employees if at least 70% of all employees were eligible to participate in the plan, permitting a plan to satisfy the requirements if it covered 56% of all employees. I.R.C. § 410(b) (1985). If a plan failed to satisfy these strict mathematical tests, the employer could attempt to demonstrate to the IRS that the plan's eligibility criteria did not, as a factual matter, discriminate in favor of officers, shareholders, or highly-compensated employees. *Id.* As Professor Wolk observed, "Congressional pension oversight committees became concerned that these tests were permitting too large a disparity in the coverage percentages of highly and non-highly compensated employees and were therefore insufficient to ensure broad, nondiscriminatory coverage of rank-and-file employees." JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 283 (3d ed. 2000). Under the new coverage rules, the mathematical tests compare coverage rates for the highly compensated group and for the non-highly compensated employees group. I.R.C. § 410(b)(1)

added a new provision to the Internal Revenue Code that required every plan to cover at least the lesser of 40% of the workforce or fifty employees.<sup>48</sup> To increase benefits for rank-and-file employees, Congress limited the degree to which a plan's benefit formula could be integrated with Social Security;<sup>49</sup> created a category of plan – the top heavy plan, in which benefits are concentrated in the accounts of "key employees" – that requires accelerated vesting standards and at least a minimum benefit for all non-key employees;<sup>50</sup> accelerated the statutory vesting standards for plans generally;<sup>51</sup> and imposed caps on the compensation that could be considered in benefit formulas.<sup>52</sup>

We want to emphasize that during this period Congress did not create important additional incentives to encourage plan formation. Moreover, the addition of new statutory provisions to improve effective coverage came during an era when actual coverage rates dipped somewhat, and it has been suggested that the coverage dip was, in part, a response to the cost of the new regulations.<sup>53</sup> It also, however, has been suggested that the coverage dip occurred primarily because of the severe economic downturn in the middle of the 1980s.<sup>54</sup> In any event, the coverage rates crept back to the 50% mark in the 1990s, possibly attributable to the strong economy we enjoyed during that decade.<sup>55</sup>

It should also be said that it is difficult to assess whether the decline in coverage rates had a substantive negative aggregate effect on workers in the

(1994). The latter group must have a coverage rate that is at least 70% of the former group's. *Id.* If the plan does not meet the mathematical test, it must pass an alternative test – the average benefits test – which requires that plans use a nondiscriminatory and reasonable business classification, meet a less exacting mathematical test, and meet an average benefit requirement, under which the average benefit rate for the non-highly-compensated employees must be at least 70% of the average benefit rate for the highly-compensated employees. I.R.C. § 410(b)(2) (1994).

48. I.R.C. § 401(a)(26)(A)(i)-(ii) (1994).

49. See generally I.R.C. § 416 (1994); Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 433 (1987).

50. I.R.C. § 416 (1994).

51. For example, the ten-year forfeiture period for plans using cliff vesting was reduced to five years, and the fifteen-year period for graded vesting was reduced to seven years. Compare I.R.C. § 411(a)(1), (2) (1983) (providing for ten-year forfeiture period and fifteen-year graded vesting) with I.R.C. 411(a)(1), (2) (1985) (providing for five-year forfeiture period and seven-year graded vesting).

52. I.R.C. § 401(a)(17) (1994); see Norman Stein, *Beware: The Rich Are Getting Richer; "Reforms" in the House Bill Won't Much Help Rank-And-File Workers Save for Retirement*, L.A. TIMES (op ed), July 31, 2000, at 9 (discussing how increased compensation caps could result in reduced benefits for rank-and-file employees).

53. Robert L. Clark et al., *The Effects of Pension Nondiscrimination Rules on Private Sector Pension Participation* (Sept. 22, 2000), available at [http://www.brook.edu/es/events/pension/09clark\\_mul\\_schieb.pdf](http://www.brook.edu/es/events/pension/09clark_mul_schieb.pdf).

54. Munnell & Sunden, *supra* note 33, at 7.

55. *Id.*

bottom two earnings quintiles because we have no statistics on what we earlier referred to as the effective coverage rate. We do not know, for example, how many of the people who lost coverage during the 1980s were actually accruing more than trivial benefits or whether they were vesting in the benefits they did accrue. It seems likely that the firms most sensitive to the costs of the new regulatory measures, and thus most likely to drop their plans in response to tightened regulation, would have been those firms whose plans provided little more than nominal coverage to their low- and moderate-income employees. It is thus conceivable that the decline in nominal coverage rates was due principally to firms dropping plans that failed to satisfy the purpose of the tax subsidy, at least as we have defined it for purposes of this Article.

If congressional strategy during the 1980s was to tighten regulations to improve substantive coverage for the lower income quintiles, agency regulatory action sometimes moved in the opposite direction. The most striking instance occurred when the Department of Treasury (Treasury) issued regulations permitting firms to establish pure cash-or-deferred plans.<sup>56</sup> These regulations interpreted 1978 legislation that added section 401(k) to the Internal Revenue Code. In enacting § 401(k), Congress's primary intent was to permit firms to offer employees a choice between an end-of-the-year cash bonus or a contribution to a profit-sharing plan,<sup>57</sup> an issue whose resolution Congress had deferred in 1974 when it enacted ERISA.<sup>58</sup> (Such plans had been in existence prior to ERISA.)<sup>59</sup> Despite the limited purpose of the 1978 legislation, the language of § 401(k) was drafted broadly and could be read to allow firms to permit employees to defer regular compensation, not just end-of-the-year bonuses. Amid some level of uncertainty about whether the legislation should be read this broadly, Treasury issued regulations that endorsed this position.<sup>60</sup> The regulations unleashed a storm over the next two decades; the 401(k) plan became the most popular form of new qualified plan.<sup>61</sup> The participation rates in such plans are lower for employees in the bottom income quintiles than for other employees in traditional employer-funded plans.<sup>62</sup>

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56. See, e.g., Jay Thomas Scholz, *Pension Consultant Behind Today's Popular 401(k) Retirement Plan*, SAN ANTONIO BUS. J. (Mar. 9, 2001), available at <http://sanantonio.bcentral.com/sanantonio/stories/2001/03/12/focus8.html> (detailing history of 401(k) plan).

57. *Id.*

58. See DAVID L. RAISH, CASH OR DEFERRED ARRANGEMENTS, TAX MANAGEMENT PORTFOLIO 358 (3d ed. 1997) (explaining Internal Revenue Service issuance of proposed salary reduction regulation and ERISA moratorium).

59. *Id.*

60. See Scholz, *supra* note 56.

61. See Munnell & Sunden, *supra* note 33, at 15.

62. For example, according to CPS data from 1993, the participation rate for low-income employees in traditional defined benefit plans was 83%, while the participation rate in 401(k) plans for such employees was only 40%. See Ron Gebhardt Bauer, *Written Materials Accom-*

Similarly, Treasury proposed in 1989 and promulgated in 1991 nondiscrimination regulations that tolerate if not encourage substantial disparities in benefit accruals between the highly-compensated employee and the non-highly compensated employee, particularly in smaller plans.<sup>63</sup> At least with respect to smaller firms, the regulations often permit the construction of plans that maximize benefits for the highly compensated while minimizing benefits for low- and moderate-income workers. The so-called "cross-testing rules,"<sup>64</sup> permitting some firms to establish defined contribution plans in which the most highly compensated employees receive annual account allocations that are more than twenty times the allocations provided for lower-paid employees, have been the most visible and controversial part of the regulations enabling firms to effect such goals.<sup>65</sup>

It is difficult to assess the net effect of the legislative and regulatory modifications of the nondiscrimination rules during the 1980s, but our sense is that these opposing forces probably left the overall effective coverage rate for the lower two quintiles about where it was at the beginning of the 1980s, despite the congressional agenda to improve benefits for low- and moderate-income workers. Had the regulatory agenda been consistent with congressional policy decisions, it is possible that the level of effective coverage would have increased even though the nominal coverage levels may have declined.

The congressional climate changed dramatically in the 1990s. Congress shifted its focus from improving benefit adequacy for the low- and moderate-income employee to broadening the opportunities for affluent plan participants to save on a tax-deferred basis and making plan sponsorship more attractive to firms that did not sponsor plans. Increasing the amount that affluent participants can contribute to qualified plans does not directly effect benefit adequacy for low- and moderate-income employees, although it does come with a high tax-expenditure price tag and does not reflect a concern with increasing retirement adequacy for such employees.<sup>66</sup> The approach that Congress has

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panying Testimony Before ERISA Advisory Council, July 17, 2001, at 3 (on file with *Washington and Lee Law Review*).

63. Treas. Reg. § 1.401-(a)(4) (1994). See generally Peter A. Christensen & Marjorie Martin, *A Complete Guide to Age-Weighted Defined Contribution Plans*, in 1 PENSION AND PROFIT SHARING 2D, NO. 42, 15 (1992).

64. See Treas. Reg. § 1.401(a)(4)-8 (1994) (providing rules for cross-testing); Stein & Orszag, *supra* note 40, at 630 (providing similar illustrations and arguing that cross-tested plans should be limited); Edward A. Zelinsky, *Is Cross-Testing a Mistake? Cash Balance Plans, New Comparability Formulas and the Incoherence of the Nondiscrimination Norm*, 49 BUFF. L. REV. 575 (2001) (providing illustrations of how cross-testing works and defending cross-tested plans); Edward A. Zelinsky, *Cross-Testing, Nondiscrimination, and New Comparability: A Rejoinder to Mr. Orszag and Professor Stein*, 49 BUFF. L. REV. 675 (2001).

65. Stein & Orszag, *supra* note 40, at 643.

66. For example, the Joint Committee on Taxation estimated that the pension legislation that President Clinton vetoed in 2000 would have carried a tax cost of \$16.1 billion. 27 Pens.

crafted to cajole new plan sponsorship, however, will likely have the effect of reducing benefit adequacy for low- and moderate-income workers because the approach is one of reduced regulation.<sup>67</sup>

Congressman Benjamin Cardin, an architect of this approach, wrote a legislative package, now largely enacted, that he helped design, with the goal that

H.R. 10 will help extend the opportunity for tax-favored retirement savings for workers in small businesses. To date, only a small proportion of small businesses have set up retirement savings plans for their workers.

Among companies with fewer than 100 employees, 80% of the work-force has no pension or retirement plan. Compared to large companies, where 75% of the work force has a retirement plan, this demonstrates the urgent need to make it easier for small businesses to set up retirement savings plans. H.R. 10 will remove burdensome regulations that have made it difficult for small businesses to give their workers the opportunity to save for retirement.<sup>68</sup>

Burdensome regulations make a convenient windmill for any brave legislative knight. Indeed, everyone can agree that regulations should be simplified when a regulatory burden is generated by complexity alone, i.e., when plan sponsors have to pay consultants to decipher the meaning of a regulation's requirement or to determine whether they are in regulatory compliance ("first, let's pay all the lawyers"). But the regulations that Congress recently eliminated or softened did not impose complexity burdens of this variety. The burdens they imposed were simply the financial costs of providing nontrivial levels of benefits for low- and moderate-income employees.

Congress first loosened such regulations when it created safe-harbor 401(k) plans and the similar SIMPLE plan in 1996 legislation.<sup>69</sup> In traditional 401(k) plans, employers must undergo an annual testing procedure designed to ensure that utilization of the plan by a firm's non-highly compensated employees bears a nontrivial relationship to utilization by highly compensated employees.<sup>70</sup> The testing process, and correction process if the plan fails to

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& Ben. Rep. (BNA) 1669 (1980). The amendments to the pension tax provisions embodied in this legislation were ultimately rolled into the Economic Growth and Tax Relief Reconciliation Act of 2001.

67. See, e.g., Benjamin L. Cardin, *Pension Bill Will Allow Greater Saving for Retirement*, at [http://www.house.gov/cardin/published\\_articles/PENSION\\_REFORM\\_WILL\\_ALLOW\\_GREATER\\_SAVINGS\\_FOR\\_RETIREMENT.htm](http://www.house.gov/cardin/published_articles/PENSION_REFORM_WILL_ALLOW_GREATER_SAVINGS_FOR_RETIREMENT.htm) (stating that pension reform embodied in H.R. 10 will allow greater savings for retirement).

68. *Id.*

69. Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1421, 110 Stat. 1795.

70. See I.R.C. § 401(k)(3) (1994) (describing standards for application of participation and discrimination).

satisfy the testing, impose administrative burdens on the sponsoring firm, but a firm may design its plan and procedures to simplify these processes.<sup>71</sup>

The 1996 legislation permitted employers to eschew the testing process if the plan design provides that the employer will make matching contributions for the employee equal to 100% of the first 3% of compensation that the employee voluntarily contributes to the plan, and equal to 50% of the next 2% of compensation.<sup>72</sup> For small employers, the same legislation created SIMPLE, where the plan satisfies the nondiscrimination rules if it provides a match for only the first 3% of compensation.<sup>73</sup> These types of plans are easier to administer than traditional 401(k) plans, but the result will be smaller benefits for low- and moderate-income employees in many plans.

The rationale for these safe-harbor nondiscrimination requirements is that they reduce regulation without reducing benefits because empirically we know that employees at all income levels respond to employer matches in traditional 401(k) plans.<sup>74</sup> But the matching requirements, which permit the employer to condition ultimate receipt of the match on three years of vesting service, were arbitrarily selected without empirical verification that the matches would be adequate to stimulate employee contributions.

It is more problematic that these plans alter firm incentives that might result in a less vigorous employee response to matches in these new plans than to matches in traditional 401(k) plans. In traditional 401(k) plans, firms have an interest in encouraging significant levels of plan participation by non-highly-compensated employees so that highly-compensated employees can maximize their contributions under the special 401(k) nondiscrimination testing rules. Firms sponsoring SIMPLE and safe-harbor 401(k) plans lack such incentive. Indeed, the incentives run in the direction of discouraging plan participation by nonhighly-compensated employees, sparing the firm the burden of making the matching contributions for them. Thus, there is reason to believe that the net effect may be plans that provide less saving for non-highly compensated employees than do traditional 401(k) plans.

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71. See RAISH, *supra* note 58, at 27-29 (exploring various methods employers have at their disposal to ensure compliance with 401(k)(3) tests).

72. I.R.C. § 401(k)(12)(B) (1994). As an alternative, the employer can make 3% non-elective contributions on behalf of all plan participants. I.R.C. § 401(k)(12)(C) (1994).

73. I.R.C. § 401(k)(11)(B)(i)(II) (Supp. V 1999). As an alternative, the employer can make 2% of non-elective contributions on behalf of all plan participants. I.R.C. § 401(k)(11)(B)(ii) (Supp. V 1999).

74. See, e.g., *Social Security: Budgetary Tradeoffs and Transition Costs*, 107th Cong. 34 (2001) (testimony of Sylvester J. Shieber) (noting that based on survey of 401(k) plans, approximately 90% of employees earning more than \$35,000 participated in 401(k) plan offering 100% matching contribution and that 75% of employees earning between \$25,000 and \$35,000 participated).



If the effect were only to induce some firms that do not have plans to adopt new plans, the overall effect on retirement savings for moderate-income employees would, of course, be positive, even if small. The issue then would be simply whether the additional coverage was worth the tax cost of these new plans. But when Congress created these new types of plans, it also encouraged firms with traditional 401(k) plans and firms with employer-funded retirement plans to consider substituting a SIMPLE or safe-harbor 401(k) plan for their existing plan. If firms do this, an actual decline in the retirement savings of their moderate-income employees might occur. In order for the aggregate effect on moderate-income employees to be positive, the number of employees who were not covered by any plan prior to their firm's adoption of a SIMPLE or safe-harbor 401(k) would have to exceed the number of employees who save less as a result of their firms replacing an existing plan with a SIMPLE or safe-harbor 401(k) plan.

There is some reason to believe that negative effects – lost savings – may predominate. First, most firms that do not sponsor plans say they lack sufficient business profit to justify adopting a plan.<sup>75</sup> Firms in which business profits are low typically will not have any highly-compensated employees. These firms were within an effective safe harbor before the introduction of the SIMPLE and safe-harbor 401(k) plan because plans with no highly compensated employees automatically pass nondiscrimination testing. The SIMPLE and safe-harbor 401(k) plans add little to the mix of incentives for such firms. Second, the recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRA) increases the amounts that employers and employees can contribute to SIMPLE and safe-harbor 401(k) plans, making them attractive to a wider range of firms already sponsoring these plans.<sup>76</sup>

EGTRA also increases the deductibility limits for individual retirement plans to \$5,000, providing some small business owners with an alternative to adoption of a qualified plan that requires them to provide some benefits to their employees.<sup>77</sup>

EGTRA also includes several provisions that allow firms to design their plans with lower levels of benefits for low- and moderate-income employees than the Internal Revenue Code permitted pre-EGTRA. Section 416 of the Internal Revenue Code, for example, mandates that "top-heavy" plans – plans

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75. EBRI SURVEY, *supra* note 32.

76. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 611(f), 115 Stat. 38, 99 (2001) [hereinafter EGTRA]. EGTRA amends I.R.C. §§ 401(k)(11) and 408(p) and increases the maximum SIMPLE elective contributions from \$6,000 to \$10,000, although the increase is phased in \$1,000 increments through 2005. *Id.* EGTRA increased the overall limits for 401(k) plans, including safe harbor 401(k) plans, from \$10,500 to \$15,000, although the increase again is phased in through 2006. EGTRA § 611(d)(1) (2001) (amending I.R.C. § 402(g)(1)).

77. EGTRA § 601(a)(2) (2001) (amending I.R.C. § 219(b)(5)).

in which "key employees" have accumulated 60% or more of the aggregate benefits under the plan – must provide accelerated vesting and a minimum benefit for each plan participant.<sup>78</sup> For defined contribution plans, the minimum benefit is generally equal to 3% of a participant's compensation.<sup>79</sup> In many 401(k) plans and in so-called "new comparability" plans, the sole reason that most non-highly paid employees are accumulating even a marginally meaningful benefit is this minimum contribution rule.<sup>80</sup> (In new comparability plans, key employees may be receiving benefits in excess of 20% of their compensation.<sup>81</sup>) EGTRA makes several definitional changes that will reduce the number of plans that must provide minimum benefits to non-key employees.<sup>82</sup> It also permits top-heavy plans to credit employer matching contributions toward the minimum benefit requirement.<sup>83</sup>

Although critics of the top-heavy rules complain about the complexity of annually determining top-heavy status,<sup>84</sup> this complexity can be avoided entirely if the plan provides for three-year vesting and minimum contributions equal to 3% of compensation. Thus, to a considerable extent, the complexity created by the top-heavy rules is voluntary on the part of plan sponsors. Moreover, when Congress asked the General Accounting Office (GAO) to study top-heavy plans, the resulting report found that few plans experienced substantial cost or difficulty in coping with the top-heavy rules.<sup>85</sup> Congress ignored the GAO's findings when passing EGTRA. Because of the changes in the top-heavy rules, participants in some existing small plans will find their future benefits reduced, sometimes substantially.

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78. I.R.C. § 416(b), (c) (1994).

79. *Id.* § 416(c)(2) (1994).

80. See U.S. GEN. ACCOUNTING OFFICE, "TOP HEAVY" RULES FOR OWNER-DOMINATED PLANS (GAD/HEHS-00-141), REPORT TO THE CHAIRMAN, SPECIAL COMMITTEE ON AGING, U.S. SENATE 13-15 (2000) [hereinafter REPORT ON "TOP HEAVY RULES"] (discussing minimum required employer contribution for workers in top-heavy defined contribution plans).

81. *Id.* See generally Stein & Orszag, *supra* note 40.

82. EGTRA § 613(a) (2001) (amending I.R.C. § 416(i)(1)(A)); EGTRA, § 613(c)(1) (2001) (amending I.R.C. § 416(g)).

83. EGTRA § 613(b) (2001).

84. See, e.g., ASS'N OF PRIVATE PENSION & WELFARE PLANS, SUMMARY AND HIGHLIGHTS OF H.R. 1102, THE COMPREHENSIVE RETIREMENT SECURITY AND PENSION REFORM ACT OF 1999 ("The repeal or significant modification of the top-heavy rules has been an important APPWP priority since the rules' inception. The top-heavy rules have been viewed as a strong disincentive to plan formation by small employers. . . . The simplifications to the top-heavy rules contained in H.R. 1102, several of which APPWP developed, should encourage small employers to adopt plans and will eliminate an administrative burden for large employers.").

85. See REPORT ON "TOP HEAVY" RULES, *supra* note 80, at 29-30 (finding that administrative costs to ensure compliance with top-heavy rules generally appear to be minor part of employer's total administrative costs to operate tax-qualified plan).

EGTRA weakened another Internal Revenue Code provision – the compensation cap – which is designed to increase benefits for all but the highest paid employees.<sup>86</sup> The compensation cap limits the amount of compensation that an employer may consider in a plan's benefit formula. The effect of the compensation cap generally comes from the intersection between a plan's benefit formula and the dollar limits that Internal Revenue Code § 415 imposes on contributions and benefits.<sup>87</sup> Before EGTRA, the statute set the compensation cap at \$150,000 with adjustments for cost of living increases.<sup>88</sup> In the year 2000, the inflation-adjusted index reached \$170,000.<sup>89</sup>

In 2000, a firm could contribute a maximum amount of \$30,000 to a defined contribution plan.<sup>90</sup> Assume that a firm's owner had \$200,000 in compensation and that the firm's owner wanted the maximum \$30,000 contribution to his account. Also assume, for purposes of simplicity, that the Internal Revenue Code required the firm to contribute the same percentage of compensation for each plan participant.<sup>91</sup> Because the compensation cap forces the plan to treat the firm owner as if he were earning \$170,000, the plan would have to use a 17.65% contribution rate for *all* participants in order to provide the owner \$30,000.<sup>92</sup>

EGTRA boosted the compensation cap to \$200,000.<sup>93</sup> Applying the new compensation cap to the above facts, the firm could reduce the contribution rate to 15% and still provide the owner with \$30,000. The only effect of

86. I.R.C. § 401(a)(17) (1994).

87. Before EGTRA, § 415(b) limited a normal retirement life annuity under a defined benefit plan to \$120,000, which by the year 2001 had been adjusted to \$140,000 to reflect cost-of-living increases. Section 415(c) limited annual allocations under a defined contribution plan to \$30,000, which in the year 2000 had been adjusted to \$35,000 to reflect cost-of-living increases. The interaction between the compensation cap and § 415, in the context of a defined contribution plan, is described in the text accompanying *infra* notes 90-92.

88. I.R.C. § 401(a)(17) (1994).

89. I.R.S. Notice 2000-66, 2000-52 C.B. 600.

90. I.R.C. § 415(c) (2000).

91. The Internal Revenue Code's nondiscrimination rules nominally require that benefits or contributions are proportionately the same on a compensation basis for highly and non-highly compensated employees. *See* I.R.C. § 401(a)(5) (1994). The proportionality norm, however, is a weak one, and an employer may – through Social Security integration, *see* I.R.C. § 401(l) (1994); Treas. Reg. § 1.401(a)(4)-6 (as amended in 1998), through age-weighting, *see* Treas. Reg. § 1.401(a)(4)-8 (as amended in 1993); Stein & Orszag, *supra* note 40, and through other methods, *see* Stein & Orszag, *supra* note 40 – provide benefits for highly compensated employees that bear a higher percentage to their pay than benefits for rank-and-file employees bear to their pay. However, generally speaking, a benefit that reflects a higher percentage of pay for highly-paid employees will increase benefits for rank-and-file employees as well.

92. This again assumes that benefits will bear the same relationship to pay for both highly-compensated and rank-and-file employees.

93. EGTRA § 611(c) (2001) (amending I.R.C. § 401(a)(17)).

this would be to reduce the contributions to the other plan participants to 15%.<sup>94</sup>

EGTRA made other changes that will permit or encourage some existing plans to reduce benefits for low- and moderate-income employees.<sup>95</sup> Realistically, none of these changes are likely to result in substantial new plan sponsorship. To the extent that the changes do encourage the formation of new plans by lowering the amount of benefits that plans must provide to low- and moderate-income employees, those plans will provide lower levels of benefits to such employees than the Internal Revenue Code has required previously. Moreover, another likely effect of these EGTRA changes will be the reduction of benefits for low- and moderate-income employees in many already-existing plans.

The only provision aimed directly at helping low- and moderate-income workers is a government matching credit for certain lower-income individuals who elect to contribute to an employer cash or deferral plan or to an individual retirement account.<sup>96</sup> The maximum credit is 50% of the amount contributed (up to \$2,000 per person or \$4,000 for married couples), which applies to individuals with \$15,000 or less in adjusted gross income.<sup>97</sup> The credit then drops to 20% for individuals with income over \$15,000 but less than \$16,250, and then drops to 10% for those with up to \$25,000 of income.<sup>98</sup>

There are a number of reasons why the credit is not likely to contribute significantly to the retirement security of those to whom it is aimed. First, the credit is nonrefundable.<sup>99</sup> The child care and dependent care credits, which can reduce to zero the taxes paid by some families whose adjusted gross income is less than \$15,000, will cause some otherwise eligible taxpayers to derive no benefit from the credit.<sup>100</sup> Moreover, the \$1,000 maximum credit nominally available under the statute is probably not actually available to any taxpayer

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94. The effect could be substantial. For an employee with \$50,000 in compensation, the decrease in contributions for the year would be \$1,000. Assuming that the employee is age thirty-five, continues to participate in the plan, and earns \$50,000 each year until he retires at age sixty-five, the employee's loss in retirement income would exceed \$100,000 at age sixty-five, assuming an 8% rate of return.

95. For example, safe-harbor 401(k) plans under I.R.C. § 401(k)(12) will no longer be subject to the top-heavy provisions. EGTRA § 416(g)(4)(H) (2001). EGTRA also permits employees over age fifty to make \$5,000 elective contributions (which Congress calls "catch-up" contributions), which are not subject to nondiscrimination utilization testing. In some firms in which owner employees over age fifty do not wish to make the maximum permitted contribution to a defined contribution plan, the firm could reduce firm contributions for all employees and the higher paid employees could make up the difference through these additional elective contributions.

96. EGTRA § 618(a) (2001) (adding § 25B to Internal Revenue Code).

97. I.R.C. § 25B(b) (2001).

98. *Id.*

99. *Id.* § 25B(h) (2000).

100. I.R.S. Announcement 2001-106, 2001-44 I.R.B. 1.

after 2002 because the taxpayer must have no more than \$15,000 in adjusted gross income to be eligible for the 50% credit, and the *maximum* possible tax liability for such a taxpayer is \$970.<sup>101</sup> This will generally be lower because of dependency deductions and tax credits.<sup>102</sup> Second, the income thresholds are not indexed to inflation, a stark departure from almost every other retirement plan limit in the Internal Revenue Code.<sup>103</sup> Third, the credit declines to 20% once a taxpayer's adjusted gross income exceeds \$15,000 and to 10% once his income exceeds \$16,250.<sup>104</sup> It is questionable whether a credit of 10% or even 20% will be sufficient to motivate low-income workers to save for retirement. Fourth, unless it is renewed, the credit will be available for only five years.<sup>105</sup> Finally, Congress designed the credit in apparent ignorance of the work of behavioral economists, whose research suggests that workers avoid savings programs in which their paycheck declines.<sup>106</sup> Such behavior may be the perceived effect under a credit in which people must make voluntary deferrals to an employer plan.<sup>107</sup> Many people in the income range eligible for the credit will not have sufficient sums of money to make an end-of-the-year IRA deposit to qualify for the credit. It also may be unrealistic to believe that potential recipients of the credit will make small weekly IRA deposits. In our view, the most likely effect of the credit will be to reduce slightly the taxes of low- and moderate-income people who are already saving in their employer's 401(k) plan. The credit also may attract a few recent college graduates in their first half-year in the workforce, when their income may reflect only a partial calendar year of full-time earning. In our view, it is improbable that the credit will create significant new stores of retirement savings for the people it purportedly targets.

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101. In 2002, the marginal tax rate on the first \$6,000 of taxable income will be 10%, and the rate on taxable income then rises to 15% for all income over \$6,000. Assume now there is a single taxpayer with \$15,000 in adjusted gross income who takes the standard deduction and one exemption deduction. If we assume that the standard deduction and exemption amount for the year 2000 (\$4,400 and \$2,800) remains unchanged – and it will of course be adjusted upwards to reflect increases in the cost of living – the taxpayer's taxable income will be \$7,800 and the tax liability (and maximum credit) would be \$970.

102. If the taxpayer from the previous footnote had a dependent child and did *not* take the child or dependent care credit, her taxable income would be reduced to \$5,000, and her tax liability (and maximum credit) would be \$500.

103. Compare, e.g., I.R.C. § 25B(b) (2001) with I.R.C. §§ 219(b)(5)(C), 401(a)(17)(B), 402(g)(4), 408(p)(2)(E)(ii), 415(d) (2001).

104. I.R.C. § 25B(b) (2001).

105. *Id.* § 25B(g) (2001).

106. RICHARD H. THALER, *THE WINNER'S CURSE* 76 (1992); Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving* (Nov. 2000), available at <http://economics.uchicago.edu/download/save-more.pdf>.

107. See, e.g., Eldar Shafir et al., *Money Illusion*, 112 Q. J. ECON. 341 (1997) (contending that money illusion – tendency to think in terms of nominal rather than real monetary values – is widespread phenomenon in United States today).

The legislative decisions reflected in recent pension legislation mark a retreat from the traditional carrot/stick blueprint for the tax treatment of qualified plans, that of encouraging plan sponsorship through tax incentives for the highly-paid and of forcing plans to provide the social benefit of retirement savings for lower-paid employees through regulation. As Professor Bruce Wolk explained in 1982:

As the discrimination rules require more in the way of contributions for lower paid employees, the employer's costs increase. For any given employer, the costs may eventually exceed the benefits of covering the highly paid employees. At that point, the employer would decline to establish or continue a retirement plan. Thus, an aggressive congressional stance against discrimination might effectively preclude many lower paid employees from receiving retirement benefits. . . .

Congress could avoid the adverse effect of aggressive discrimination rules by designing rules to ensure a high level of tax subsidy in relation to employer costs. Presumably this would result in a larger number of employers establishing or maintaining plans. Rules bringing about this result, however, would risk wasting the tax subsidy. To the extent that such rules would encourage employers to establish plans by excluding lower paid employees, the subsidy would be applied ineffectively.

From Congress's perspective, the optimum level of tax subsidy is that which encourages the establishment of a retirement plan only if the social benefit of the plan equals or exceeds its costs.<sup>108</sup>

Congress has moved in the direction of higher subsidies for the highly paid and of less regulation – sweetening the carrot and softening the stick.<sup>109</sup> As Dan Halperin has noted, this will result in more but worse plans.<sup>110</sup> If the only result were the addition of new plans, the only problem would be cost: are we getting enough social benefit given the tax costs of such new plans? Because of the softening of regulations, however, a reduction of benefits for lower-paid employees in existing plans also will result.

Perhaps this suggests a paradigmatic shift in our understanding of the tax subsidy for qualified plans away from the provision of retirement savings for low- and moderate-income workers who otherwise would undersave for retirement. Perhaps the emerging understanding of the tax subsidy for qualified plans is that the subsidy should simply increase our overall national savings rate without regard to whether it helps low- and moderate-income people save

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108. Wolk, *supra* note 10, at 433.

109. EGTRA, for example, increased the limitations for both defined benefit and defined contribution plans under I.R.C. § 415. See EGTRA § 611 (2001). We have already described some of EGTRA's regulation softening. See *supra* notes 78-95 and accompanying text.

110. Halperin, *supra* note 9, at 164 (noting that under current scheme of incentives, there is always choice between fewer but better plans or less satisfactory arrangements in greater number).

for retirement. Another possible explanation for the qualified plan tax subsidy is that it introduces a consumption tax element into our tax system, providing a partial balance to the perceived bias of an income tax against savings.<sup>111</sup> A third possibility, although one that by its nature cannot be explicitly acknowledged in political discourse, is that the qualified plan subsidy is designed to indirectly provide a reduction in the effective tax rates of relatively high-income taxpayers. This explanation assumes that providing the reduction indirectly through qualified plans accords political cover to what could not be legislated directly. Finally, one might argue that the tax subsidy primarily is intended to increase retirement savings for the upper strata of the middle class. The plan participation rate for the upper-income band of the middle class is high (approximately 80%), and it is reasonable to think that some if not most of the high utilization is the tax subsidy embedded in qualified retirement plans.

We accept that the alternative explanations for the subsidy outlined above already play some role in the political sustainability of the qualified plan subsidy. But one of the explanations – the idea that the subsidy simply provides a tax rate reduction – is seldom acknowledged, and for the past forty years, none of the alternative explanations have been nearly as instrumental to the discussion as what we have sometimes called the qualified plan paradigm. This explanation has been the most important for the past forty years in shaping the intellectual and rhetorical landscape that provides the tax subsidy its public justificatory context.<sup>112</sup> Indeed, the qualified plan paradigm is so dominant that the sponsors and supporters of recent pension legislation argue that such proposals are consistent with this paradigm, even though the proposals could be justified more easily under one or more of the other explanations.<sup>113</sup>

This argument points to the heart of an important concern: the debate over retirement security is distorted. By arguing that their pension "reforms" will expand coverage and enrich benefits for low- and moderate-income work-

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111. See RICHARD IPPOLITO, *AN ECONOMIC APPRAISAL OF PENSION TAX POLICY 2* (1990) (arguing that federal rules governing pensions represent means of enforcing statutory marginal income tax rates because without special tax treatment of pension trust funds, marginal tax rates would increase by order of magnitude for earnings set aside for retirement consumption).

112. See Stein, *supra* note 21, at 195-96 (describing hypothesis of qualified plan paradigm).

113. See AM. COUNCIL OF LIFE INS., *PORTMAN-CARDIN: A PENSION REFORM BILL FOR SMALL BUSINESS AND WOMEN* (2001), available at <http://www.acli.com/public/media/pubs/portman-cardin.pdf> (last visited Jan. 18, 2002); Cardin, *supra* note 67; Press Release, The Profit Sharing Council of America, *PSCA Urges Inclusion of Portman/Cardin in Tax Relief Package* (Feb. 13, 2001), available at <http://www.psc.org/press/p2001/feb13.html> ("[T]hese reforms also will result in expanded coverage in the small business sector, which employs a disproportionate share of lower-income and female workers. It also will remove barriers to progressive businesses that want to make significant profit-sharing contributions to their employee's retirement accounts.").

ers and thus are consistent with the traditional qualified plan paradigm, the congressional champions of EGTRA close off serious consideration of other measures that might in fact have expanded coverage and enriched retirement benefits for these workers. If instead they had sought to justify their proposals on the basis of one of the alternatives for the qualified plan subsidy, we might have expected two positive political outcomes: explicit discussion of the merits and costs of their suggested justification (whatever it might be), and consideration of proposals to help low- and moderate-income workers build retirement security apart from the universe of employer-sponsored plans. Inevitably, the latter consideration should include proposals to modify Social Security in this direction.

### *III. The Problems of Linkage*

Certainty and understanding are virtues in a retirement program whether or not it is designed to provide an old age or disability pension, and whether or not the program provides income replacement or in-kind benefits, such as medical benefits. Participants who do not understand what they are promised, or who cannot rely with certainty on the promises made, may reach a time of dependency with inadequate resources – a time when it is too late to make alternative arrangements. This Part of the Article considers this idea of linkage between employee understanding of a plan's benefit and the employee's ultimate receipt of the expected benefit.

The problems of linkage occur when participants believe employers are promising something different from that for which they have an enforceable contractual right. Despite the goal of the Employee Retirement Income Security Act of 1974 (ERISA) of ensuring the certainty of the benefit promise, the problems of linkage continue to be a fixture in the retirement benefits landscape. This Part of the Article reviews some linkage problems that haunt participants in private pension plans.

Before considering those problems, however, we want to observe that the increased linkage of the expected and actual retirement benefit comes with a price: it restricts employer flexibility, which could result in fewer plans and/or lower benefits in a voluntary system such as ours, in which neither plan sponsorship or plan design is mandated. Thus, we approach the issue of imperfect linkage less as a critique of our current private system than as a fact whose effects on employee retirement security should inform the Social Security debate.<sup>114</sup>

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114. However, many believe the system can provide better protections for employee benefit expectations. See generally Jay Conison, *Suits for Benefits Under ERISA*, 54 U. PITT. L. REV. 1 (1992); Dana M. Muir, *ERISA Remedies: Chimera or Congressional Compromise?*, 81 IOWA L. REV. 1 (1995); Norman P. Stein, *ERISA and the Limits of Equity*, 56 LAW & CONTEMP. PROBS. 1 (1993).



### A. *The Reservation of Rights Clause and Retiree Health*

Competently designed employee benefits plans generally include a waiver of rights clause under which the sponsoring firm can modify or terminate the plan at any time. Such clauses sometimes begin with strong endorsements of the plan and then disavow any obligation to employees to continue to maintain the plan. For example, General Motors' retiree health plan included the following language:

General Motors believes wholeheartedly in this Insurance Program for GM men and women, and expects to continue the Program indefinitely. However, GM reserves the right to modify, revoke, suspend, terminate, or change the Program, in whole or in part, at any time.<sup>115</sup>

A law review note written in 1940 referred to such clauses as weasel clauses.<sup>116</sup>

Federal courts often have held that such clauses are enforceable, despite employer conduct suggesting that a plan was permanent and could not be modified or terminated.<sup>117</sup> A Sixth Circuit case involving the General Motors clause quoted above is typical.<sup>118</sup> General Motors distributed numerous plan descriptions over the years, some of which included reservation of rights language, but the majority of which did not.<sup>119</sup> The plan's description included language promising lifetime benefits: for example, "[y]our basic health care

115. *Sprague v. Gen. Motors Corp.*, 133 F.3d 338, 394 (6th Cir. 1998).

116. See Note, *Legal Status of Private Industrial Pension Plans*, 53 HARV. L. REV. 1375, 1379 (1940). A list of weasel clauses can be found in LUTHER CONANT, A CRITICAL ANALYSIS OF INDUSTRIAL PENSION SYSTEMS 79 (1922). See also ARTHUR D. CLOUD, PENSIONS IN MODERN INDUSTRY 131-33, 186-204 (1930) (discussing reservation of rights clauses).

117. See, e.g., *Sprague*, 133 F.3d at 394 (holding that because employer's summary plan descriptions unambiguously reserved right to amend plan, acceptance statements signed by retirees or written representations provided by employer did not supersede or modify plan); *In re Unisys Corp. Retiree Med. Benefit "ERISA" Litig.*, 58 F.3d 896, 907 (3d Cir. 1995) (holding that while retirees may have relied to their detriment on their interpretation of summary plan descriptions as promising vested or lifetime benefits, unambiguous descriptions applied to such benefits); *Moore v. Metro. Life Ins. Co.*, 856 F.2d 488, 492 (2d Cir. 1988) (holding that absent showing tantamount to proof of fraud, ERISA welfare plan is not subject to amendment as result of informal communications between employer and plan beneficiaries). There are, however, cases to the contrary. See, e.g., *Rossetto v. Pabst Brewing Co.*, 217 F.3d 539, 547 (7th Cir. 2000) (holding that collective bargaining agreement between employer and union contained latent ambiguity and thus retired employees rebutted presumption that their health benefits would not continue beyond collective bargaining agreement duration); *United Steelworkers v. Connors Steel Co.*, 855 F.2d 1499, 1505 (11th Cir. 1988) (affirming trial court decision that language in insurance agreement obliged employer to provide insurance benefits after expiration of negotiated labor contracts). These cases are generally based on interpretations of collective bargaining agreements. See generally Catherine L. Fisk, *Lochner Redux: The Renaissance of Laissez-Faire Contract in the Federal Common Law of Employee Benefits*, 56 OHIO ST. L.J. 153 (1995).

118. *Sprague*, 133 F.3d at 394.

119. *Id.* at 409 (Martin, C.J., dissenting).

coverages will be provided at GM's expense for your lifetime."<sup>120</sup> Moreover, a large group of the retirees who retired under special early retirement programs also received additional oral and written communications promising them retiree medical care.<sup>121</sup> Many of them signed early retirement contracts after receiving a description of their retirement benefits that included the continuation of health care coverage at no cost to them.<sup>122</sup> Finally, according to a lawyer for the participants, a long history of uninterrupted free retiree health care, continuous improvements in such health care, and a corporate ethos and employee culture of which retiree benefits were an important part, all reinforced the employee belief that the rights were permanent.<sup>123</sup>

In 1987, more than a quarter century after General Motors adopted the plan, it modified the health care plan in ways that substantially increased retiree costs and decreased plan benefits.<sup>124</sup> A group of retirees brought a civil action against General Motors and prevailed in district court with a decision in favor of the early retirees who had waived other rights for a package that

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120. *Id.*

121. *Id.* at 412-13. For example, GM personnel workers told some early retirees that the retirees "would get their basic health insurance for the rest of their life free . . . . We told everybody that." *Sprague v. Gen. Motors Corp.*, 843 F. Supp. 266, 283 (E.D. Mich. 1994), *aff'd*, 92 F.3d 1425 (6th Cir. 1996), *rehearing granted & judgment vacated by* 102 F.3d 204 (6th Cir. 1996) *and* 133 F.3d 388 (6th Cir. 1998). Other retirees were told that "they would continue to receive the same health care program they had as employees as long as they lived, at no cost to them." *Id.* at 284; *see also* *Sengpiel v. B.F. Goodrich Co.*, 970 F. Supp. 1322, 1326 (N.D. Ohio 1997) (noting release that employees signed in favor of employer expressly stated "I hereby release and forever discharge the Company from any other obligations under its present or future Employee Benefits Program except for payments of future premiums on my adjusted Group Life Insurance and payment of Hospitalization Program benefits to the extent described in applicable programs"), *aff'd*, 156 F.3d 660 (6th Cir. 1998).

122. *Sprague*, 843 F. Supp. at 308.

123. Telephone Interview with Christopher MacKaronis, attorney for *Sprague* plaintiffs (July 2001). There was also trial testimony to this effect from a former Director of Health Care for General Motors, who when asked about the reservation-of-rights clause found in some of the benefit summaries, stated:

[I]f you look at and think about the culture that existed within General Motors over those years during which employees were repeatedly told that these coverages would be continued for life, and so when there's an admonition that there may be modifications or changes, I think that -- that reading has to do with the past experience that we've had of making some changes. Those changes were always improvements. There was not an admonition that -- that this program can be drastically reduced or eliminated.

*Sprague v. Gen. Motors Corp.*, 843 F. Supp. 266, 304-05 (E.D. Mich. 1994), *aff'd*, 92 F.3d 1425 (6th Cir. 1996), *rehearing granted & judgment vacated by* 102 F.3d 204 (6th Cir. 1996) *and* 133 F.3d 388 (6th Cir. 1998).

124. *Sprague v. Gen. Motors Corp.*, 133 F.3d 388, 395 (6th Cir. 1998). The costs shifted to retirees were in the form of an annual deductible and an imposition of a co-pay, the maximum impact on a retiree with family coverage was \$750 annually. *Id.*

they believed included retiree health benefits. But the Sixth Circuit reversed in part and instead held that the reservation of rights clause trumped all other representations and expectations because it was part of the written plan document. The Sixth Circuit noted:

ERISA "has an elaborate scheme in place for beneficiaries to learn their rights and obligations at any time, a scheme that is built around reliance on the face of written plan documents." To implement this scheme, ERISA requires that every plan "shall be established and maintained pursuant to a written instrument." 29 U.S.C. § 1102(a)(1). ERISA also requires, as we have said, a written summary plan description that will "reasonably apprise... participants and beneficiaries of their rights and obligations under the plan." 29 U.S.C. § 1022(a).

The writing requirement ensures that "every employee may, on examining the plan documents, determine exactly what his rights and obligations are under the plan." And the requirement lends predictability and certainty to employee benefit plans. This serves the interests of both employers and employees. "Congress intended that plan documents and SPDs exclusively govern an employer's obligations under ERISA plans." We recognize that "[t]his may not be a foolproof informational scheme, although it is quite thorough. Either way, it is the scheme that Congress devised."

Our court has consistently refused to recognize oral modifications to written plan documents. "[W]e are quite certain," we have explained, "that Congress, in passing ERISA, did not intend that participants in employee benefit plans should be left to the uncertainties of oral communications in finding out precisely what rights they were given under their plan." Therefore, the "clear terms of a written employee benefit plan may not be modified or superseded by oral undertakings on the part of the employer."<sup>125</sup>

However, the rarefied world conjured into being through judicial magic is not the world inhabited by most employees, whom employers generally condition to accept representations made by supervisory personnel. The legal distinction between a provision in the written plan document and an oral representation or written representation made outside the plan document is not one with which a typical employee is likely to be familiar. Moreover, employees generally learn best through a combination of sources, including oral and written communication from supervisors.<sup>126</sup> To privilege the formal plan

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125. *Id.* at 402-03 (citations omitted). The court also concluded that estoppel theories were unavailing, given the existence of the reservation of rights clauses. *Id.* at 404; *see also* *Int'l Union, United Auto., Aerospace & Agric. Implement Workers of Am. v. Skinner Engine Co.*, 188 F.3d 130, 152 (3d Cir. 1999) (holding that failure to distribute summary plan descriptions with reservation of rights clause did not give rise to estoppel because employer did not have fraudulent intent and no other extraordinary circumstances were present).

126. *See generally* VICTOR S. BAROCAS, *BENEFIT COMMUNICATIONS: ENHANCING THE EMPLOYER'S INVESTMENT* 15, 31-37 (1993); MICHAEL BLAND, *EMPLOYEE COMMUNICATIONS*

document over other forms of communication contradicts basic behavioral rules governing communication in the workplace.<sup>127</sup>

Reservation-of-rights clauses, even when employees are aware of them and understand that a firm might exercise its rights thereunder, create problems of certainty for employees trying to plan for their retirement security. When such clauses exist, employees cannot depend on employer-provided health benefits still being available by the time they retire, and they cannot depend on their indefinite continuation after they retire. Rational employees would make other arrangements for health care before they retire because once they retire their fixed financial resources will constrain their ability to engage in other arrangements.<sup>128</sup> Employees who respond in this manner would probably attach little or no value to the employer's suggestion that it will provide its retirees with health care. Receipt of such benefits, then, might be regarded by lucky retired employees as a windfall. In such an environment, a firm probably would not make such quasi-promises to its employees.

### *B. The Implicit Bargain in Defined Benefit Plans*

In traditional defined benefit plans, benefits are backloaded, that is, the present value of the annual benefit accrual increases geometrically in value as

IN THE 1980s (1980); WILLARD V. MERRIHUE, *MANAGING BY COMMUNICATION* (1960); ROBERT NEWCOMB & MARG SAMMONS, *EMPLOYEE COMMUNICATIONS IN ACTION* 106-26 (1961).

127. *Id.*; see *Moore v. Metro. Life Ins. Co.*, 856 F.2d 488, 490 (2d Cir. 1988) (noting that employer used filmstrips to explain and to promote various benefits available under different plans).

128. In one case, a district court observed:

Once an employee has rendered his years of service to the employer, his "sweat equity," and has taken retirement, the employee furnishes little to the employer that generates revenue; hence, the employer may perceive little risk in reducing the level of benefits previously promised. Since an active employee generates revenues beyond his wage and costs of overhead, he possesses the economic leverage to bargain for benefits. . . . The employer who amends the company vacation policy reducing annual vacation days from two weeks to two days will experience a mass exodus of his labor pool. But, the employer who doubles the medical insurance premiums for his retirees will receive the increased monthly checks from all those who can afford it and cannot find an adequate substitute source of protection. The retirees have no economic leverage, hence no bargaining position to check modifications of benefits made solely in the interest of their former employer. To permit the enforcement of termination/modification clauses without a showing of good cause has the effect of reducing the status of hard earned welfare plan benefits to mere gratuities. Accurate financial forecasting or retirement planning is impossible because continuation of the benefits is subject to the discretion of an employer.

*Musto v. Am. Gen. Corp.*, 615 F. Supp. 1483, 1496-97 (M.D. Tenn. 1985), *rev'd in part*, 861 F.2d 897, 902 (6th Cir. 1988) (holding that provision of group medical insurance did not imply that retired employee had to give consent before employer could exercise reserved right to determine new premium contribution for retired employee).

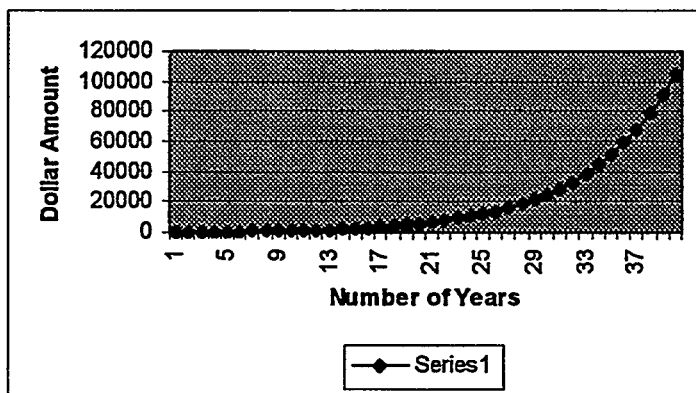
an employee ages. There are two reasons for backloading. First, the value of a dollar of promised retirement income is directly related to the length of the discount period – the interval between benefit accrual and retirement.<sup>129</sup> Thus, the older the employee, the shorter the discount period and the greater the value of a dollar's worth of benefit. Second, many defined benefit plans are based on a formula incorporating the employee's final pay – for example, 1% of final pay times years of service.<sup>130</sup> An increase in compensation for one year increases the value not only of that particular year's nominal benefit accrual but also of the nominal benefit accrual of all prior years.

Under a traditional defined benefit plan, then, the bulk of a long-term employee's benefits are "earned" in the last years of the employee's service. Indeed, an employee who spends most of his working life with a single firm will earn more than half of a final-pay defined benefit during the last ten years of his employment.<sup>131</sup> The implicit bargain reflected in a traditional defined benefit plan is that the firm valued loyalty and long service and will reward both in the last years of employment with substantial defined benefit accruals.

129. See Norman P. Stein, *Simplification and I.R.C. § 415, 2 FLA. TAX REV. 69, 76 (1994)* (discussing time-value of money in context of contribution to defined benefit plans); Edward A. Zelinsky, *ERISA and the Emergence of the Defined Contribution Society*, 57 N.Y.U. INST. ON FED. TAXATION: EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION §§ 6.01, 6.04(1), at 16-17 (Alvin D. Lurie ed., 1999) (providing examples of contributions need to fund defined benefit plan in various stages of employee's career).

130. See DAN M. MCGILLET AL., *FUNDAMENTALS OF PRIVATE PENSIONS* 204 (7th ed. 1996) (explaining final average formula as type of benefit formula whereby final average formula benefits are accrued on basis of participant's average compensation during specific period).

131. The following graph indicates the present value of each year's annual benefit accrual in a plan that provides a benefit equal to 2% of final pay, assuming an assumed rate of return of 8%, a 5% salary scale, an initial salary of \$20,000, and an annuity conversion factor of ten at age sixty-five.



The firm, however, has the legal right to terminate a defined benefit plan or to modify its benefit formula prospectively.<sup>132</sup> The financial gain to the employer who does so can be substantial. While an employee's accrued benefit at the time of a termination or modification is protected, the employee is deprived of the implicit bargain the employer offered, that is, the substantial benefits the employee would have earned during the last period of employment.<sup>133</sup> The loss to a middle-age employee can be substantial.

### C. Other Defined Benefit Plan Issues

There are two other significant linkage problems in defined benefit plans. One involves the subsidized early retirement benefit included in some plans for people who retire after a certain age or after a specified number of years of service.<sup>134</sup> An employer can amend the plan, however, to eliminate or reduce such subsidies for most employees.<sup>135</sup> For example, a plan might provide that an employee with thirty years of service can retire at age fifty-five.<sup>136</sup> An employee who is age fifty-five with twenty-five years of service begins planning to retire at age sixty, but in the interim, the employer amends the plan to eliminate the benefit. While the employee still can retire at age sixty with the benefit calculated based on his service and salary as of age fifty-five, the firm has reduced the employee's age-sixty retirement benefit.

The second significant defined benefit plan linkage issue concerns underfunded plans. A defined benefit plan's ability to meet benefit commitments depends on the level of employer funding, the success with which the plan has invested its assets, and the demographic characteristics of its participants. A defined benefit plan can fail as a result of employer undercontribution, unsuccessful investments, or unfavorable demographic experience. In cases of plan failure, the federally chartered and regulated Pension Benefit Guaranty

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132. See I.R.C. § 401(a)(2) (1994) (permitting employer to recover surplus assets after terminating plan); ERISA § 404(d), 29 U.S.C. § 1104(d) (1994) (discussing fiduciary obligations when employer decides to terminate plan); I.R.C. § 411(d)(6) (1994) (prohibiting retroactive benefit decreases).

133. See RICHARD A. IPPOLITO, PENSIONS, ECONOMICS AND PUBLIC POLICY 233-52 (1986) (discussing economic implications of loss to employee and breakage of implicit bargain between employer and employee).

134. See MCGILL ET AL, *supra* note 130, at 218 (noting that general practice of using early retirement factors more favorable than actuarially equivalent ones is referred to as "subsidized early retirement").

135. The only limitation in the Internal Revenue Code is I.R.C. § 411(d)(6), which generally does not permit a retroactive reduction in such a benefit. I.R.C. § 411(d)(6) (1994). An employer may, however, amend a plan to reduce or eliminate the benefit for years of service after the amendment.

136. See, e.g., I.R.S. Rev. Rul. 85-6, 1985-1 C.B. 133 (noting qualified defined benefit plan).

Corporation (PBGC) takes over the plan and pays participants guaranteed benefits.<sup>137</sup> That can be far less than the employee's vested accrued benefits.<sup>138</sup>

#### D. Standard of Judicial Review of Benefit Denials

The Supreme Court in 1989 resolved a circuit split over whether a court reviewing a benefit denial should accord deference to the plan administrator's factual findings and plan interpretations.<sup>139</sup> The Court held that judges should defer to a plan administrator if the plan's language vested the plan administrator with discretionary authority to decide benefit claims.<sup>140</sup> This approach to judicial review of benefit denials creates linkage issues because a participant is not entitled to the court's interpretation of a plan's provisions or resolution of factual issues; the participant only is entitled to the court's determination of whether the plan administrator's interpretation of the plan or findings of fact is unreasonable.

This has been particularly problematic when there are disputed factual issues, such as whether a participant is totally disabled. In those cases, courts in many circuits focus not on the extent of disability of the participant, but on whether the plan administrator behaved arbitrarily in determining that the participant was not totally disabled.<sup>141</sup> In numerous cases, courts have ruled

137. ERISA § 4022, 29 U.S.C. § 1322 (1994).

138. For example, the PBGC does not guarantee subsidized early retirement benefits, benefits that resulted from plan amendments within sixty months of plan termination, or monthly annuity benefits over a specified level, which for plans terminating in 2001 is \$3,392.05. See Richard D. Hylton, *Don't Panic About Your Pension – Yet*, FORTUNE, Apr. 18, 1994, at 121, 127-28 (illustrating case in which person's early retirement benefit declined in value by more than 50% as result of PBGC takeover of plan).

139. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 105 (1989). See generally Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1128-38 (1988); John H. Langbein, *The Supreme Court Flunks Trusts*, 1990 S. CT. REV. 207 (1991); Norman P. Stein, *ERISA and the Limits of Equity*, 56 LAW & CONTEMP. PROBS. 71, 94-100 (1993).

140. *Firestone*, 489 U.S. at 115. The precise holding of the Court in *Firestone* is that a plan is a contract and that a reviewing court should review the plan de novo unless the "plan gives discretion to an administrator," in which case courts should use a narrower standard of review, such as an arbitrary and capricious standard. However, if the plan administrator or fiduciary vested with discretionary interpretive power "is operating under a conflict of interest, that conflict must be weighed as a factor in determining whether there is an abuse of discretion." *Id.* at 155 (quoting RESTATEMENT (SECOND) OF TRUSTS § 187, cmt. d (1959)).

141. See, e.g., *Clapp v. Citibank, N.A. Disability Plan*, 262 F.3d 820, 828-29 (8th Cir. 2001) (noting that defendant's conclusion that plaintiff was not permanently disabled under plan was not unreasonable under facts); *Delta Family-Care Disability & Survivorship Plan v. Marshall*, 258 F.3d 834, 843 (8th Cir. 2001) (concluding that when record reflected conflicting medical opinions, plan administrator did not abuse its discretion in finding employee was not disabled); *Fletcher-Merritt v. NorAm Energy Corp.*, 250 F.3d 1174, 1180 (8th Cir. 2001) (concluding that because plan administrator offered reasonable explanation for its decisions,

that a plan administrator did not behave arbitrarily in denying disability benefits to a participant whom the Social Security Administration has found to be totally disabled.<sup>142</sup>

### E. *Obscure Plan Provisions*

Employee benefit plans sometimes include provisions that are not understood by plan participants and have the effect of reducing the benefits to which employees believed the plan entitled them. We offer two examples from the files of a pension clinic at the University of Alabama School of Law.

In the first case, a plan provided a retirement benefit that included an offset for worker's compensation benefits.<sup>143</sup> The summary plan description mentioned, but did not describe, the offset in one sentence in its forty pages. The union that had negotiated a series of collective bargaining agreements with the employer was unaware of the provision, as were the management personnel at the division in which the plan participant worked. The participant experienced a work-related injury and filed for worker's compensation

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court should not disturb decisions even if another reasonable, but different, interpretation may be made); *Goad v. Lockheed Martin Energy Sys., Inc.*, No. 99-6615, 2001 U.S. App. LEXIS 8834, at \*11 (6th Cir. May 2, 2001) (upholding defendant's plan determinations as rational in light of plan's provisions); *Cochran v. Trans-General Life Ins. Co.*, Nos. 99-2102/99-2447, 2001 U.S. App. LEXIS 7829, at \*10 (6th Cir. Apr. 13, 2001) (concluding that decision of plan administrator to deny plaintiff continued benefits was reasonable); *Dwyer v. Metro. Life Ins. Co.*, No. 00-1514, 2001 U.S. App. LEXIS 1541, at \*24 (4th Cir. Feb. 5, 2001) (finding defendant's decision to deny plaintiff's claim reasonable result of defendant's claim review process); *Wojciechowski v. Metro Life Ins. Co.*, No. 00-7359, 2001 U.S. App. LEXIS 828, at \*8 (2d Cir. Jan. 12, 2001) (noting that denial of benefits not clear error of judgment); *Pari-Fasano v. ITT Hartford Life & Accident Ins. Co.*, 230 F.3d 415, 420-21 (1st Cir. 2000) (noting that receipt of Social Security disability benefits was not determinative of eligibility for long-term disability benefits and insurer was not unreasonable in terminating benefits without conducting vocational assessment). *But see Myers v. Hercules, Inc.*, 253 F.3d 761, 768 (4th Cir. 2001) (concluding that defendant reached its decision to terminate plaintiff's benefits by unreasoned process and that evidence did not support this decision); *Ingram v. Martin Marietta Long Term Disability Income Plan*, 244 F.3d 1109, 1114-15 (9th Cir. 2000) (holding that because plan did not confer discretion on administrator to grant or deny benefits, court would review denial de novo); *Postma v. Paul Revere Life Ins. Co.*, 223 F.3d 533, 538 (7th Cir. 2000) (concluding that plain language of plan did not grant discretion to administrator and appropriate standard of review was de novo).

142. *See, e.g., Elliot v. Sara Lee Corp.*, 190 F.3d 601, 604 (4th Cir. 1999) (concluding that because Social Security determinations are not binding on administrator and disability standards are not analogous, administrator was under no obligation to weigh agency's disability determination more favorably than other evidence); *Pagan v. NYNEX Pension Plan*, 846 F. Supp. 19 (2d Cir. 1995) (concluding that Social Security determinations are not binding on ERISA plans); *Anderson v. Operative Plasterers' & Cement Masons' Int'l Ass'n Local No. 12*, 991 F.2d 356, 358 (7th Cir. 1993) (holding that pension plan gave trustees discretion to deny disability benefits even if Social Security Administrator had found disability).

143. The plan, summary plan description, and complaint are on file with the *Washington and Lee Law Review*.



benefits. He ultimately settled his worker's compensation claim for a lump sum payment of \$50,000, 20% of which went to his lawyer. The offset formula in the plan reduced his monthly pension to zero. The participant was unaware that his settlement would have any effect on his pension.

In the second case, a large national employer sponsored a defined benefit plan.<sup>144</sup> The plan's benefit formula used a multiple of years of service and the average compensation during the highest consecutive five years of pay during the most recent ten years of employment. A participant in the plan took part-time status, reducing her pay by approximately 50%. At the time she took part-time status her accrued retirement benefit, a monthly annuity that began at age sixty-five, was approximately \$800 per month. In her sixth year of part-time status, her accrued benefit began to drop in value as the ten-year reference period began dropping off her full-time compensation years. Her benefit ultimately declined in value to approximately \$500 per month despite her additional years of service for the firm. Her benefit would have thus been greater had she quit rather than continued to work part-time. She was unaware that her decision to work part-time could reduce her already-accrued pension benefits, although she might have been able to determine this before she took part-time status if she had had a pension consultant review the plan document. Such cases, although perhaps not common because they involve a plan provision and an employee adversely affected by it, can result in devastating effects on affected individuals.<sup>145</sup>

#### *F. Theft and Mismanagement of Plan Assets*

Although ERISA imposes myriad rules governing the conduct of individual and corporate actors who control or manage employee benefit plan assets,<sup>146</sup> there have been numerous cases involving the abuse of plan assets. Some cases involve bad judgment or excessive risk-taking by investment managers.<sup>147</sup>

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144. The employer was Northwestern Airlines. A copy of its pension plan is on file with the *Washington and Lee Law Review*.

145. The employer ultimately converted the plan to a cash balance plan. As part of the conversion, the employer amended the plan to use the highest consecutive five years of compensation rather than the highest five years within the final ten years of employment, so the participant ultimately was able to collect her unreduced benefit. But prior to the conversion to a cash balance format, the employer had rejected the participant's legal claim that the pension-reducing provision was unlawful.

146. See ERISA, § 404(a)(1), 29 U.S.C. § 1104(a)(1) (1994) (imposing prudential and loyalty duties on plan fiduciaries); ERISA § 408, 29 U.S.C. § 1108 (1994) (creating prohibited transaction rules).

147. *Lanka v. O'Higgins*, 810 F. Supp. 379 (N.D.N.Y. 1992) (finding that although 98% of plan assets were invested in stock of three large yet troubled companies, there was no breach of ERISA fiduciary duty of prudence)

Others involve churning by investment managers.<sup>148</sup> Others involve firms, often capital-strapped, dipping into plan assets or delaying payment of employee elective deferrals to 401(k) plans.<sup>149</sup> Some involve plan managers selling fraudulently valued company stock to the plan or the plan selling it to plan managers.<sup>150</sup>

The consequences to participants of a decline in plan assets attributable to mismanagement or theft vary depending on the circumstances. If plan fiduciaries or plan participants learn of a resulting decline in plan assets, they can bring a civil action to recoup plan loss.<sup>151</sup> They also may bring the loss to the attention of the Department of Labor, which can investigate<sup>152</sup> and, if necessary, initiate civil proceedings against the wrongdoers<sup>153</sup> or refer the matter for criminal prosecution.<sup>154</sup> In some cases, however, the firm and its principals may lack the ability to make the plan whole, or procedural or practical obstacles may prevent correction.<sup>155</sup>

In defined contribution plans, an uncorrected plan loss will result directly in a loss of retirement benefits. In defined benefit plans, the immediate impact of a plan loss will generally be on the employer, who will face increased future contribution obligations or a reduced potential reversion on plan termination. The loss, however, will in some cases result in reduced benefits to participants. If the PBGC takes over a plan that has become insolvent, partici-

148. See, e.g., *Olson v. E.F. Hutton & Co.*, 957 F.2d 622, 628 (8th Cir. 1992) (involving allegations of churning); *Radiology Ctr., S.C. v. Stifel, Nicolaus & Co.*, 919 F.2d 1216, 1218 (7th Cir. 1990) (same).

149. The Department of Labor has filed numerous suits in the last several years against employers that delayed deposit of employee elective deferrals into 401(k) plans. See, e.g., *Labor Files Lawsuit for Misuse of Plan Assets*, 28 Pens. & Ben. Rep. (BNA) 1662 (June 19, 2001); *Court Judgment Involves Alleged Unsecured Loans*, 23 Pens. & Ben. Rep. (BNA) 1564 (June 5, 2001); see also *Explanation the Dep't of Labor's Enforcement of ERISA, Focusing on Pension Security: Hearing Before the Subcomm. on Labor of the Common Labor and Human Resources*, 101st Cong., 109 (1990) (statement of Karen Ferguson, Director of Pension Rights Center, Washington, D.C.) (commenting that there is "case after case of . . . trustees who have used pension plans as their personal piggy banks. The abuses [include] situations where small business owners have dipped into plans to meet a cash flow crunch, help out a relative, or take advantage of a too-good-to-be-true investment opportunity.").

150. *Howard v. Shay*, 100 F.3d 1484, 1490 (9th Cir. 1996) (finding breach of fiduciary duty when fraudulently-valued company stock sold from plan to plan managers); *Eyler v. Comm'r*, 88 F.3d 445 (7th Cir. 1996) (noting that plan managers sold company stock back to plan at more than stock's worth).

151. ERISA § 502(a)(2)-(3), 29 U.S.C. § 1132(a)(2)-(3) (1994).

152. ERISA § 504, 29 U.S.C. § 1134 (1994).

153. ERISA § 502(a)(2), (5), (6), 29 U.S.C. § 1132(a)(2), (5), (6) (1994).

154. ERISA § 501, 29 U.S.C. § 1131 (1994).

155. For example, statute-of-limitations issues can arise in cases involving plan investments. See, e.g., *Radiology Ctr., S.C. v. Stifel, Nicolaus & Co.*, 919 F.2d 1216, 1218 (7th Cir. 1990).

pant benefits will be reduced by the amount they exceed PBGC guarantees.<sup>156</sup> Participants may also suffer indirect reductions to future benefits if the plan sponsor reacts to a loss in plan assets by either terminating the plan or amending the plan to reduce the rate of future benefit accruals.

#### *G. Some Thoughts About Linkage and Defined Contribution Plans*

In the past two decades, defined contribution plans have replaced defined benefit plans as the most common form of retirement vehicle.<sup>157</sup> Defined contribution plans generally do not create linkage problems; the employee receives exactly what is in his or her account, and there is no difference between what the employee expects to receive from the plan and what the employee in fact receives from the plan. However, the deeper structural issue in linkage is not the disparity between what employees believe they have been promised and what they actually have been promised, but rather it is the gap between what the employee perceives to be the value of his or her benefits and the actual value of those benefits. From this perspective, defined contribution plans pose an issue similar to leakage because of a tendency for employees to overvalue the benefits they will receive from defined contribution plans.<sup>158</sup>

There are two ways in which employees apparently overvalue defined contribution accounts. First, many employees overestimate the rate of return they are likely to achieve on their accounts.<sup>159</sup> Second, employees tend to overestimate the amount of retirement income their account will provide once they retire.<sup>160</sup> Educational efforts, of course, may counter these effects to a certain extent.

#### *IV. The Problem of Leakage*

The goal of retirement plans is to provide a continuing source of income for people after they leave the labor market. In an ideal world, free of inflation, a plan would provide its participants a periodic and constant annuity until

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156. ERISA § 4022, 29 U.S.C. § 1322 (1994).

157. In 1977 there were 121,655 defined benefit plans and 280,972 defined contribution plans. The defined benefit plans covered almost thirty-five million employees while the defined contribution plans covered slightly more than fifteen million. In 1996, there were 63,657 defined benefit plans and 632,566 defined contribution plans. The defined benefit plans covered approximately forty-one million employees while the defined contribution plans covered over fifty million. U.S. DEP'T OF LABOR, PRIVATE PENSION PLAN BULLETIN, ABSTRACT OF 1996, FORM 5500 ANNUAL REPORTS, at tbls. E1 & E5 (Winter 1999-2000). See generally Zelinsky, *supra* note 129 (noting rise of popularity of defined contribution plans).

158. See Testimony of Dallas Salisbury, President of Employee Benefits Research Institute, U.S. Department of Labor, Advisory Council on Employee Welfare and Pension Benefit Plans, Working Group on Preparing for Retirement 65, 68-75 (Apr. 9, 2001).

159. *Id.* at 71-72.

160. *Id.* at 73.

death. In the case of married participants, a plan would provide a periodic and constant annuity until the later of the death of the participant or his spouse, perhaps with an appropriate downward adjustment after the first death to reflect the reduced expenses of a one-pension household.<sup>161</sup> Each year, however, retirement plans pay billions of dollars of benefits that are not so applied. Participants either spend these funds before retirement or exhaust these funds too quickly in retirement.

The most cited form of leakage is the lump sum payment of pension benefits when a participant leaves employment or takes an in-service distribution from a 401(k) or other profit-sharing plan.<sup>162</sup> Plans may choose to pay participants cash when they leave if the benefit has a present value of less than \$5,000 or if the employee consents.<sup>163</sup> Statistics derived from the 1993 Current Population Survey indicate that 20% of the population who received lump sums rolled over the entire amount into an IRA or other qualified plan, 40% rolled over part of their distribution, and 40% did not roll over any part of their distribution.<sup>164</sup> In sum, participants rolled over approximately two-thirds of the total value of the distributions. Hewitt Company, in a survey of its 1996 database, indicated that 40% of participants rolled over their distributions, representing 79% of the total distributed assets.<sup>165</sup> One should also note that not all of the money rolled over into individual retirement accounts will stay there because amounts in such accounts are easily accessible to the IRA owner.<sup>166</sup>

The two studies noted above suggest that older participants and participants with large distributions (two groups with considerable overlap) are the

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161. Even in a world without inflation, one could make this argument because the cost of living will probably increase in the last years of life, when the individual is likely to have greater health costs and may need long-term care. Moreover, even an individual who does not require intensive care may need help with some routine tasks (such as cooking and transportation) that they were able to perform for themselves earlier in retirement. See, e.g., *DRIVING MISS DAISY* (Warner Bros. 1989) (demonstrating elderly woman's need for assistance with routine tasks when Dan Ackroyd hires Morgan Freeman to drive Jessica Tandy).

162. See *CASHING OUT OUR FUTURE?*, *supra* note 12 (discussing various reports that leakage problems are often caused by lump sum payments and in-service distributions).

163. I.R.C. § 411(a)(11)(A) (Supp. V 1999).

164. *CASHING OUT OUR FUTURE?*, *supra* note 12. Professor Daniel Halperin and Alicia Munnell, however, report that only 40% of employees rolled over lump sum distributions in 1996, which, it should be said, reflected an increase from 35% in 1993. Their figures are based on an Employee Benefits Research Institute survey of large-plan lump sum payouts. DANIEL I. HALPERIN & ALICIA MUNNELL, *HOW THE PENSION SYSTEM SHOULD BE REFORMED* 11 (Brookings Inst. Conference, Sept. 17, 1999), available at <http://www.brook.edu/es/erisa/99papers/erisa10.pdf>.

165. *CASHING OUT OUR FUTURE?*, *supra* note 12.

166. There are no restrictions on when an individual can make withdrawals from an individual retirement account. However, the government imposes a 10% excise tax on some withdrawals from individual retirement accounts prior to the year in which the IRA owner attains age 59.5. I.R.C. § 72(t) (1994).

most likely participant groups to roll over their distributions.<sup>167</sup> This should not, however, be a source of comfort. For purposes of thinking about leakage from a retirement system, it makes more sense to project the future dollar value of a distribution to the retirement age of the distributee. The following chart shows the amount of lost benefits at age sixty-five for a \$5,000 distribution using 6%, 8%, and 10% interest assumptions for a twenty-year old, a thirty-year old, a forty-year old, a fifty-year old, and a sixty-year old.

Age	6%	8%	10%
20	68,823	159,602	364,452
30	38,430	83,927	140,512
40	21,460	34,242	54,174
50	11,983	15,861	20,886
60	6,691	7,347	8,052

Using the mid-range assumption, the thirty-year old's failure to preserve a \$5,000 distribution causes a loss of almost \$75,000 of retirement benefits.

Congress has attempted to control leakage, in part, through the assessment of a 10% excise tax on premature plan distributions that are not rolled over.<sup>168</sup> A distribution is generally premature if it is made to a participant prior to the year in which the participant attains age 59.5.<sup>169</sup> Over the last fifteen years, however, Congress has carved out exceptions to the penalty tax for plan and IRA withdrawals to pay for college tuition,<sup>170</sup> to pay health care expenses,<sup>171</sup> or to help pay the down payment on a first home.<sup>172</sup>

Similarly, Congress limits in-service withdrawals from 401(k) plans to cases of hardship.<sup>173</sup> Congress permits hardship withdrawals in circumstances similar to those that result in a waiver of the 10% excise tax, for example, to pay medical expenses, to pay tuition, to purchase a first home, and other hardships, such as the purchase of a car in some situations.<sup>174</sup>

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167. See CASHING OUT OUR FUTURE?, *supra* note 12 (noting 89% rollover rate for individuals over age sixty and 95% rollover rate for distributions exceeding \$100,000).

168. I.R.C. § 72(t) (1994).

169. *Id.*

170. *Id.* § 72(t)(2)(E) (Supp. V 1999).

171. *Id.* § 72(t)(2)(B) (Supp. V 1999).

172. *Id.* § 72(t)(2)(F) (Supp. V 1999).

173. *Id.* § 401(k)(2)(B)(i)(iv) (1994).

174. Treas. Reg. § 1.401(k)-1(d)(2) (2001).

One can argue that pre-retirement leakage from safe retirement plans is not invariably a bad thing. Purchasing a home can be an important investment for retirement, as can reducing high interest debt. If the home purchase or debt reduction would not otherwise have taken place, perhaps permitting access to retirement funds for such purposes is defensible policy. Moreover, one can defend allowing access to retirement savings to pay for a child's education on general policy grounds. To the extent it will enhance the child's lifetime earnings and thus put the child in a better financial position, the child's education might be considered an asset that enhances the parent's old age security.

Some commentators argue that employees would be less likely to make elective deferrals to 401(k) plans if they could not access their accounts in times of financial stress.<sup>175</sup> Thus, in a voluntary retirement system in which employee willingness to participate is necessary to the system's viability, it is essential to fashion a policy compromise between locking up benefits until retirement and encouraging voluntary participation by giving employees pre-retirement access to their benefits in certain circumstances.

Discussion of leakage generally focuses only on participant access to retirement plan assets prior to reaching retirement age. However, if the purpose of qualified retirement plans is to ensure adequate income in retirement, premature exhaustion of benefits (before death) or failure to exhaust assets in retirement (by death) are also forms of leakage. The former is a source of leakage if we conceptualize the idea of retirement security as a method of providing a sufficient and generally steady stream of income after an individual permanently leaves the labor force because of age or disability. Front-loading consumption by drawing down financial resources early in retirement is inconsistent with this goal, and thus, one may characterize it as a form of leakage. Moreover, in an economy in which some level of inflation is a permanent feature and in a world in which expenses, particularly medical expenses, increase with age, some degree of backloading of retirement benefits may be necessary to maintain a stable standard of living. In addition, dying without exhausting retirement resources and leaving the excess assets to nondependent heirs is arguably a form of leakage from a system designed to provide retirement income.

One may take issue with these broader conceptions of the idea of retirement leakage. In particular, such a description of leakage suggests the appropriateness of placing limits on personal autonomy and choice. If such limits are justifiable, it is because our private-sector retirement system is tax-subsidized and has as its public purpose the provision of retirement income.

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175. See CASHING OUT OUR FUTURE?, *supra* note 12 (noting 68% participation rate in plans that do not permit hardship withdrawals and 78% participation rate in plans that do permit such withdrawals).

Accepting such limits, however, suggests that the only way to eliminate post-retirement leakage is through mandatory, inflation-indexed annuitization of retirement benefits for the lifetime of an individual and, in most cases, the individual's spouse or domestic partner.

Recent pension legislation and trends suggest that some of the problems of post-retirement leakage are worsening and will continue to worsen. In the last two decades, there has been a shift from defined benefit plans, in which annuitization is common, to a defined contribution world in which it is not.<sup>176</sup> Moreover, the creation of cash-balance and similar types of defined benefit plans, which state benefits in the form of a notional account balance rather than a life annuity, has increased the likelihood of a cash-out on separation of service and has decreased the likelihood of annuitization on retirement.<sup>177</sup>

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRA) includes provisions that will exacerbate leakage problems. First, EGTRA greatly increases the attractiveness of profit-sharing plans over money-purchase plans, making it likely that many firms will abandon the latter plan form.<sup>178</sup> Money purchase plans, however, include an important anti-leakage feature: a married participant generally must obtain spousal consent before taking a benefit distribution in any form except a qualified joint-and-survivor annuity.<sup>179</sup> Spousal consent to a lump sum payment is not mandatory in a profit-sharing plan.

EGTRA also increases the attractiveness of section 401(k) plans over other forms of qualified plan forms.<sup>180</sup> We suspect, although we are not aware of any empirical research verifying this suspicion, that participants have a greater sense of immediate ownership of accounts to which they voluntarily contribute than they do of benefits provided by an employer-sponsored plan. A stronger sense of ownership will often carry with it a stronger aversion to government control over access to retirement savings for non-retirement usage. That most section 401(k) plans include provisions permitting hardship withdrawals provides some indirect evidence for this view.

176. See generally WILLIAM G. GALE ET AL., UNDERSTANDING THE SHIFT FROM DEFINED BENEFIT TO DEFINED CONTRIBUTION PLANS (Brookings Inst. Conference, Sept. 17, 1999), available at <http://www.brook.edu/es/erisa/99papers/erisa2.pdf>, see also Zelinsky, *supra* note 129 (noting rise in popularity of defined contribution plans).

177. See generally *What Are Cash Balance Plans*, CONTINGENCIES, Sept./Oct. 1999, at 18 (discussing mechanics of cash balance plans).

178. Prior to EGTRA, an employer could deduct contributions to a profit-sharing plan up to 15% of compensation, a limit that did not apply to money-purchase pension plans. I.R.C. § 404(a)(3) (1994). EGTRA increased this limit to 25%. EGTRA § 616(a)(1)(A) (2001).

179. I.R.C. § 401(a)(11)(B) (1994).

180. For example, EGTRA § 611(d)(1) increases the limits of elective deferrals from \$10,500 to \$15,000; EGTRA § 613 exempts safe-harbor 401(k) plans from the top-heavy rules; EGTRA § 631(a) introduces special catch-up contributions made on an elective deferral basis for participants over age fifty; EGTRA § 632 exempts elective contributions from the employer's deduction limits; and EGTRA § 617(a) creates Roth 401(k) plans.

There is also some encouraging news about leakage. First, pre-retirement leakage may diminish as educational efforts stress the value of saving for retirement in tax deferred vehicles.<sup>181</sup> Second, EGTRA does include some provisions that make it mildly easier to roll over assets between different forms of tax-qualified plans, although the rules have long permitted roll overs to individual retirement accounts and annuity contracts.<sup>182</sup>

Overall, however, the problems of leakage are difficult ones for our private pension system. It is difficult to envision a strong and politically viable natural constituency supporting legislative adoption of meaningful controls on leakage from the private pension system.

### *V. Social Security Privatization*

The problems of leverage, leakage, and linkage in private sector retirement plans have implications for the debate over suggestions to privatize Social Security. All three issues represent gaps in the private pension system for which the Social Security system, as currently structured, constitutes the public response. Privatization of Social Security would greatly weaken or, in some cases, eliminate the compensating features of the current system – mandatory and universal coverage, life annuity payments with no lump sum or early withdrawal possibility, and guaranteed wage and price indexed benefits backed by the federal taxing power. Fully or partially replacing the current defined benefit structure with a system of personal IRA-style accounts would simply import the gaps of the current private pension system into the Social Security system, inevitably resulting in much less retirement security for most workers.

#### *A. Loss of Leverage in the Private Pension System*

As discussed above, the concept of leverage has been an essential part of the voluntary private pension system for sixty years or more, primarily as a way to ensure access to retirement for workers at low- and moderate-income or wage levels. There is no concomitant need for leverage in Social Security because the public system is both mandatory and virtually universal.<sup>183</sup> However, if the value and effectiveness of leverage is decreasing in the voluntary system, does or can Social Security fill the gap, particularly for low- and moderate-wage workers? Unfortunately, the system, even as currently structured, does not provide sufficient benefits for low- and moderate-income workers to

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181. Facts from EBRI, Rollover Rates (Mar. 2000), available at <http://www.ebri.org/facts/0300fact1.htm>, indicate that job changers have increased asset rollovers from 35% in 1993 and 48% in 1998.

182. EGTRA § 641(a) (2001).

183. 42 U.S.C. § 402 (1994).



make up for the lack of private pension income, and the situation is likely to be worse under any privatized version of Social Security.

Social Security is currently the sole or primary source of retirement income for half of all Americans over age sixty-five, as well as for many young families relying on survivor benefits in the wake of the loss of the family wage earner.<sup>184</sup> The low level of benefits available under Social Security, particularly for elderly retirees and even more particularly for elderly women, generally relegates those relying primarily or solely on Social Security to living at or below the poverty line in old age.<sup>185</sup> It is very unlikely that privatizing Social Security would improve the situation of the aged poor, who, as this Article suggests, are almost sure to receive even less as a group from private sector retirement plans in the future than they have in the past.<sup>186</sup>

Moreover, middle-class aged, those comprising the ranks of skilled working class and low- to mid-level white collar and service workers during their

184. SOC. SEC. ADMIN. OFFICE OF RESEARCH, EVALUATION, AND STATISTICS, INCOME OF THE AGED CHARTBOOK, 1996, at 8-9 (1998) [hereinafter INCOME OF THE AGED CHARTBOOK].

Social Security is a source of income for nearly all the aged. More than 9 out of 10 aged units receive Social Security benefits. Asset income is the next most common source of income, received by nearly two-thirds of the aged. Less than half (41%) receive pensions other than Social Security, and only 21% have earnings. Public assistance is received by 6% and veterans' benefits by only 5%. \*Includes private pensions and annuities, government employee pensions, Railroad Retirement, and IRA, Keogh, and 401(k) payments. Social Security provides at least half of total income for a majority of beneficiaries. Social Security pays benefits to more than 90% of those aged sixty-five or older. It is the major source of income (providing 50% or more of total income) for 66% of the beneficiaries. It contributes 90% or more of income for almost one-third of the beneficiaries, and is the only source of income for 18% of them.

*Id.*

185. U.S. CENSUS BUREAU, POVERTY IN THE UNITED STATES, 1999, at 2-5 tbl.2 (2000).

186. John Mueller, *Three New Papers on "Privatizing" Social Security, One Conclusion: Bad Idea*, Address at the National Press Club (Oct. 14, 1997), transcript available at <http://www.globalaging.org/pension/us/socialsec/mueller.htm>. But see INCOME OF THE AGED CHARTBOOK, which notes that:

Social Security plays a pivotal role in reducing poverty. Although there are aged beneficiaries with family income below the poverty line,\* the poverty rate would be much higher if they did not have Social Security benefits. Nine percent of aged beneficiaries are poor, and 41% are kept out of poverty by their Social Security benefits – so that the total poverty rate without Social Security would be 50%. Although poverty rates vary considerably by marital status and race, the proportion kept out of poverty by their Social Security benefits is about 40% for all groups.

\*Based on family income of aged persons to conform with official measures of poverty.

INCOME OF THE AGED CHARTBOOK, *supra* note 184, at 10.

working lifetimes, are probably equally unlikely to see their retirement incomes improved or even maintained at current levels in any private account retirement system. Many in this second cohort of retirees may have enough private pension and savings resources that, when combined with Social Security, allow them to live comfortably above the poverty line in the context of the current system.<sup>187</sup> However, the features of the current system that most strongly underwrite the maintenance during retirement of a middle-class pre-retirement standard of living and the survival at the poverty level of poorer workers in retirement are generally absent from a privatized retirement system model. Furthermore, additional changes suggested to finance the transition to a privatized system would only further decrease the adequacy of Social Security benefits that even now are barely adequate to compensate for the gaps in the private retirement system.

First, both low- and moderate-income workers and retirees benefit from the redistributive features of the Social Security benefit structure.<sup>188</sup> Over the years, there has been substantial criticism of this redistributive feature, both from those who would like to see greater redistribution of income within a broader social welfare system<sup>189</sup> and from those who largely base their advocacy of privatization on their opposition to income redistribution in principle.<sup>190</sup> Nonetheless, the weighting in the benefit formula, which provides a higher than proportional benefit for low-wage workers and a lower than proportional benefit for high-wage workers, remains one of the few mechanisms in American social welfare programs for direct income redistribution in a largely politically successful context.

The private system, of course, can be said to mirror the income distribution of Social Security: higher-wage workers receive pension benefits that are at least proportionate to their income levels. The benefit structure of most private plans, combined with disproportionately higher coverage under plans for high-wage workers, means that as a group they receive the lion's share of

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187. SOC. SEC. ADMIN., INCOME OF THE POPULATION 55 OR OLDER, 1996, at 1 tbl. I.1, 123 tbl. VII.5 (1998).

188. 42 U.S.C. § 415 (1994); see Lee A. Sheppard, *Stripping Social Security of Its Redistributive Features*, 96 TAX NOTES 1012 (1996) (contrasting privatized system to current legislative system).

189. See, e.g., THEDA SKOCPOL, SOCIAL POLICY IN THE UNITED STATES: FUTURE POSSIBILITIES IN HISTORICAL PERSPECTIVE 265, 267-72 (1995) (advocating delivery of more income through public means to all working families); Kathryn L. Moore, *Privatization of Social Security: Misguided Reform*, 71 TEMP. L. REV. 131, 167 (1998) (suggesting that current system results in better redistribution of wealth because participants would incur increased costs under privatized system).

190. See, e.g., Jonathan Barry Forman, *Federal Tax Policy in the New Millennium: Universal Pensions*, 2 CHAP. L. REV. 95, 126 (1999) (discussing negative effects of using payroll tax system as vehicle for redistributing wealth).

private pension benefits.<sup>191</sup> This pattern is inextricably linked to the principle of leverage – without the possibility of, as it were, reverse income distribution, highly paid employees would have little incentive to participate in or to pressure employers to establish qualified pension plans. However, without the redistributive features of Social Security that provide at least some retirement income protection for low-wage workers, the degree of coverage for such workers that a privatized system might as a consequence require of private pensions would be difficult to achieve under the current tax structure.<sup>192</sup>

Second, the indexing of wage records to increases in average wages during the worker's lifetime assures the relationship of the Social Security benefit to the worker's pre-retirement income level.<sup>193</sup> Similarly, yearly automatic cost-of-living benefit increases preserve the purchasing power of the benefit in retirement necessary for maintenance of the standard of living established at retirement.<sup>194</sup> Neither feature exists in private defined benefit pension systems, and there is no real equivalent to insure adequate old age income in the private account systems suggested as replacements for Social Security.

The adequacy of any private account system, whether a private defined contribution plan, such as the popular 401(k) features of profit-sharing plans, or a privatized social security system, depends on the investment performance of amounts held in the accounts, almost more so than on the initial amounts deposited. Opponents of privatization have noted that, on average, the poor are less likely to understand investment management and are more likely to be victims of fraud or sharp sales practices. Their accounts will be smaller, which may, depending on the form of privatization implemented, result in higher fees and access to fewer investment alternatives.<sup>195</sup> Low- and moderate-income earners will have less ability to monitor their employer's timely transmittal of funds to their designated private investment accounts and less ability to monitor their investment manager's record keeping and investment performance. They will also have fewer resources to address the inevitable problems that will arise in these areas.

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191. In 1992, households in the top 20% of income levels received about 55% of all pension wealth, while households in the bottom 40% of income received only 6% of pension wealth. Also, in 1998, pension income constituted almost 30% of the income of the households in the top 20% in income, while it constituted only 10% of the income of households in the bottom 40% in income. Munnell & Sunden, *supra* note 33, at 53 tbl.7A.

192. See *supra* Part II (suggesting that current Internal Revenue Code structure provides substantial tax subsidies of qualified pension plans).

193. 42 U.S.C. § 415(a)-(i) (1994).

194. 42 U.S.C. § 415(i) (1994).

195. See, e.g., Kathryn L. Moore, *Partial Privatization of Social Security: Assessing Its Effect on Women, Minorities, and Lower-Income Workers*, 65 MO. L. REV. 341, 353-57 (2000) (noting that women, minorities, and low-income workers tend to have less investment experience and would therefore be disadvantaged under privatized system).

Moreover, any tax deferral inherent in privatized investment accounts will work to the relative advantage of high-income workers whose Social Security accounts would receive a larger tax subsidy than workers who pay tax at low marginal tax rates.<sup>196</sup> Thus, there are reasons to suspect that the benefit structure under a privatized account system will be regressive in practice, thus importing into Social Security one of the main deficiencies of the private system's reliance on leverage to increase coverage of low-wage workers.

It might be argued that although this issue is genuine, preserving an adequate minimum benefit can mitigate it. However, preserving an adequate minimum benefit for the poor may face political obstacles because the larger the minimum benefit is, the smaller the size of guaranteed benefits for other beneficiaries is likely to be. Moreover, a minimum benefit approach to preserving adequacy completely ignores the essential, broad-based middle class focus of Social Security, which the government designed to *prevent* poverty in old age by linking benefits to lifetime wage patterns rather than to alleviate it for those who are so poor in old age as to qualify for any minimum benefit that Congress might enact.<sup>197</sup>

It is perhaps more troubling that proponents of privatization have suggested paying for privatization with Social Security benefit decreases. Two of these decreases would greatly affect the elderly poor even if the current minimum benefit remained intact and also would substantially decrease benefits for middle-class retirees, resulting in a much larger group of poor elderly than currently exists.

The first suggested decrease is an adjustment to the Social Security cost-of-living formula for benefit adjustments in retirement, which, according to some studies, overstates the effects of inflation on the elderly by between .5 and 1.5%.<sup>198</sup> The effect of this overstatement is a slight upward adjustment in the real value of a Social Security benefit as the pensioner ages. Such an upward adjustment in real value is desirable for the elderly poor because they start their retirement below the poverty level. Moreover, as people age, their level of dependency, and consequently their cost of living, generally increases in real

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196. See *supra* Part II (suggesting that tax subsidies of pension plans benefit high-income workers because they have greatest capacity to save funds for retirement).

197. See Dille, *supra* note 3, at 1031-33 (noting that original intent of Depression-era formers of Social Security system was to combine entitlements based on earnings with redistribution of wealth).

198. See SOC. SEC. ADMIN., THE BOSKIN REPORT: TOWARD A MORE ACCURATE MEASURE OF THE COST OF LIVING 9-11 (1996) (discussing hypothetical increase in federal revenue and decrease in federal outlays that would result if formula adjusted); see also Christine Weller, *Shortchanging the Next Generation: Proposed Social Security Cut Would Index Benefits to 2006 Living Standards Level, Eroding Retirement Income for Everyone Thereafter*, ECON. POL'Y INST. ISSUE BRIEF NO. 162 (2001) (suggesting that cost of living adjustments should not only account for wage and price inflation, but also increases in living standards).

terms.<sup>199</sup> Finally, even those who are not "poor" when they initially retire (because they have other sources of income such as a private pension and savings) generally come to depend more and more on Social Security as a source of income precisely because Social Security benefits are indexed for inflation while other sources are not.<sup>200</sup> One should regard changing the indexation formula as an undesirable benefit cut, not simply a "technical correction," that could have dramatic effects in generally increasing poverty rates for the elderly.

The second suggested decrease would raise the Social Security normal retirement age.<sup>201</sup> Of course, calling this change "raising the retirement age" is really a misnomer because mandatory retirement is no longer legal. The only change Congress really can make is to reduce benefits for those who continue to retire at the current early or normal retirement ages, which Congress accomplished in the 1983 Social Security Amendments.<sup>202</sup> Workers are free to continue to retire at age sixty-two or at age sixty-five, but the benefits for those retiring in 2000 and later will be lower than under prior law.<sup>203</sup>

Ironically, one of the arguments for Social Security privatization is that the progressive benefit structure is illusory since the poor have, on average, shorter life expectancies than middle- and upper-income individuals.<sup>204</sup> Raising the Social Security retirement age, then, might have a disproportionate impact on the overall benefits paid to the elderly poor. Of more concern, however, is the reality that the elderly poor are likely to have had more physically-taxing jobs and lives than average, and early retirement for them may often result from necessity rather than choice.<sup>205</sup> For those poor, increasing

199. See, e.g., STAFF OF HOUSE COMM. ON WAYS AND MEANS, 103D CONG., 1993 GREEN BOOK: OVERVIEW OF ENTITLEMENT PROGRAMS 1286 tbl.15 (Comm. Print 1993) [hereinafter 1993 GREEN BOOK] (comparing income sources of poor and non-poor elderly).

200. *Id.*

201. Social Security reform proposals introduced in the 105th Congress incorporate a benefits-eligibility age increase. See S. 1792, 105th Cong. (1998) (proposing age seventy by 2073) (introduced by Moynihan and Kerrey); S. 2313, 105th Cong. (1998) (proposing age seventy by 2029) (introduced by Gregg and Breaux); H.R. 4256, 105th Cong. (1998) (proposing age seventy by 2029) (introduced by Kolbe and Stenholm); H.R. 2768, 105th Cong. (1997) (proposing age seventy by 2029) (introduced by Sanford); H.R. 2929, 105th Cong. (1997) (proposing age seventy by 2028) (introduced by Porter); H.R. 3082, 105th Cong. (1997) (proposing age sixty-nine by 2018) (introduced by Smith). For examples of other plans, see COMM. FOR ECON. DEV., FIXING SOCIAL SECURITY 2 (1997) (proposing age seventy by 2030); I REPORT OF THE 1994-1996 ADVISORY COUNCIL ON SOCIAL SECURITY 28 (1997) (proposing longevity indexed to Individual Account Plan).

202. See Social Security Amendments of 1983, Pub. L. No. 98-21, § 201, 97 Stat. 107 (increasing retirement age).

203. *Id.*

204. See Kathryn L. Moore, *The Privatization Process: Redistribution Under a Partially Privatized Social Security System*, 64 BROOK. L. REV. 969, 988 n.81 (1998).

205. The opposition in the House of Representatives in 1983 to raising the retirement age

the normal retirement age will result in a reduction of monthly income support. In addition, even for middle-class workers, the possibility of illness, injury, or layoffs forcing retirement at or before age sixty-two is very real, so that any decrease in benefits designed to induce workers to stay in the labor force longer is just as likely to push middle-class workers into poverty as it is to "raise the retirement age."

The final characteristic of Social Security that most directly contrasts the private pension system's need for "leverage" is the extent of coverage – the Social Security system is virtually universal and mandatory.<sup>206</sup> One cannot overstate the importance of universal mandatory coverage and complete portability from job to job, particularly in contrast to the voluntary nature of the private pension system. The leverage feature encourages pension formation by employers with stable, highly-paid work forces and has inevitably produced only partial coverage, largely leaving out those groups most in need of supplemental old age income – the working poor, the underemployed, and those who work no longer than two or three years at any one job.<sup>207</sup>

It may well be possible to construct a mandatory and universal privatized Social Security system if the current payroll tax withholding structure could bear the administrative burden of collecting contributions. However, the lower overall level of retirement income that would likely result from a private account system would vitiate the effect of universal coverage.

### B. Leakage

The purpose of a retirement system is to provide income after someone leaves the labor market because of age or disability. Leakage occurs when workers use assets of that system for other purposes. Discussion of leakage generally arises in the context of preretirement distributions, particularly when an employee separates from service with an employer and receives a benefit distribution. This Article, however, defines the problems of leakage more broadly to extend to disproportionate consumption of retirement savings early in retirement (both because of premature distribution of the savings to the worker and because of costs and risks of loss associated with maintenance and investment of investment accounts) and to a failure to consume fully such

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focused on this concern. See 129 CONG. REC. H1048-49 (1983) (reciting floor arguments by Congressman Richardson on Pickle Amendment to H.R. 1900 that would raise retirement age).

206. See 1993 GREEN BOOK, *supra* note 199, at 3 (estimating that 96% of workers are covered by Social Security).

207. According to the General Accounting Office, only about 21% of those who work part time or part of a year were covered by any sort of pension plan in 1998, in contrast to the almost 50% of all employees covered. U.S. GEN. ACCOUNTING OFFICE, CHARACTERISTICS OF PERSONS IN THE LABOR FORCE WITHOUT PENSION COVERAGE (GAO/HEHS-00-131), REPORT TO CONGRESSIONAL REQUESTORS 12 fig. 2 (2000).

assets by death. In addition, the period of retirement should extend to the second death for a married couple, in recognition of the reality of household planning and saving for retirement.

In the private pension system, it is likely that the problem of pre-retirement leakage will at least continue and probably increase, although educational efforts focused on the importance of preserving savings for retirement and the increased proclivity toward retirement savings of an aging workforce might mitigate the problem somewhat. Nonetheless, the trend toward cash balance defined benefit plans, defined contribution plans, and particularly 401(k) plans, in which the concept of voluntary salary deferral fosters a sense of immediate ownership and access, as well as recent legislative changes encouraging some firms to abandon their money purchase pension plans, will create additional leakage pressures on the system.<sup>208</sup>

The increasing prevalence of cash balance and defined contribution plans will also contribute to other leakage issues, particularly the failure to annuitize. Furthermore, indexation of benefits, such as post-retirement cost-of-living increases, in defined benefit plans, which commonly took place on an ad hoc basis through the mid-1980s, is now a rarity.

Social Security, in contrast, is a largely leak-proof system, with no opportunity for pre-retirement consumption of benefits (for which there is little pressure because the program provides survivor and disability benefits independently of the retirement benefit, as well as mandatory annuitized benefits on retirement).<sup>209</sup> Moreover, Social Security provides mandatory spousal benefits and indexes all benefits to the cost of living.<sup>210</sup> By design, Social Security's benefit structure and method of payment result in the provision of retirement *income*, not estate building opportunities, and thus the life annuity form, with no remainder to go to heirs, normally guarantees consumption of benefits during the retiree's lifetime.

In theory, it is possible to design a private account Social Security system with minimal leakage issues. Such a system would not permit pre-retirement access, would limit investments of accumulations to some type of indexed equity or bond funds with minimal management costs, and would require the participant to purchase an inflation-protected annuity benefit with spousal protections. While this is not the probable design for a privatized system, even this model presents substantial problems. The two most critical sources of leakage in such a system would be management of account investments at high cost, risk, and resistance to any mandatory annuity payout.

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208. See *supra* Part IV (suggesting that workers' misperceptions about real future value of their benefits often contribute to leakage).

209. See 42 U.S.C. §§ 402, 413-415 (1994) (providing for eligibility, computation, and payment of Social Security benefits).

210. *Id.*

Many commentators have raised the issue of the administrative costs of maintaining and investing private accounts as the hidden cost of privatization, and one should view the issue as a possible major source of pre-retirement, as well as post-retirement, leakage in any privatized version of Social Security. The contrast between low likelihood of leakage in the current Social Security program and the high probability of it in a privatized program should not be a surprise for the following two reasons: the current program's earnings-based entitlement structure and its lack of need for generation of profits for the managers.

First, the costs of administering the Social Security system are quite low – about one-half of one percent of the total outlay in benefits each year, a figure which covers salaries of Social Security Administration employees and maintenance of hundreds of district offices all over the country (computers, etc.).<sup>211</sup> Social Security is mostly an automatic program with few individual entitlement decisions to make (apart from the disability program). Because past earnings recorded through the payroll tax withholding system throughout workers' careers determine benefits, there is little need for personal meetings between the agency and beneficiaries and little need or scope for judgments on individual cases. Moreover, the only costs associated with running the program are government salaries; nobody gets rich from running a Social Security district office or managing the trust funds.

The administrative costs of a personal account system, on the other hand, could be extremely high, both because of the individual decision-making involved in investing millions of individual retirement accounts and because of the profits such managers would extract as the price for their advice. This cost could be as high as 10% to 25% of the amounts deposited,<sup>212</sup> primarily in fees paid to investment advisors and stock brokers and in various types of investment and transaction fees. The experiences of government pension programs in other countries that have privatized systems in whole or in part demonstrate that the fees extracted by those hired to help individual workers with their private accounts seriously diminishes individual investment returns.<sup>213</sup> The estimated effect of administrative costs and profit taking on

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211. See BD. OF TRS., FED. OLD-AGE & SURVIVORS INS. & DISABILITY INS. TRUST FUNDS, 2000 ANNUAL REPORT 6 tbl. I.C. 1 (2000) (comparing trust fund income to expenditures in 1999).

212. See LAWRENCE H. THOMPSON, ADMINISTERING INDIVIDUAL ACCOUNTS IN SOCIAL SECURITY: THE ROLE OF VALUES AND OBJECTIVES IN SHAPING OPTIONS 6 (Urban Inst., Ret. Project, Occasional Paper No. 1, 1999) (noting that under highly centralized federal model, additional annual costs are less than 0.1% of assets under management). Costs are substantially higher when the activities are highly decentralized. In the UK, charges averaged around 10%, and, in Chile, the charge ran about 19% of contributions. *Id.*; see also *infra* note 213 (estimating administrative costs in Chile by 1999 at 25%).

213. A recent monograph published by the United Nations concluded that administrative



private account returns was sufficient to induce the chairman of the last Social Security Advisory Board to tell Congress that he could no longer support a private account plan.<sup>214</sup>

One response to these concerns might be simply to insist that each individual worker can and should manage her own retirement savings in an individual account system.<sup>215</sup> This perspective, we suggest, is cynical in the extreme. Most Americans do not have the resources, the expertise, or even the time to make informed judgments on the constant, everyday level that would be necessary to ensure that their individual accounts would increase in value enough to support their retirement. Even during the heyday of the bull market, untrained investors, such as day traders who used computer trading accounts as a new form of casino gambling, frequently lost family savings and went into debt, essentially eliminating their own retirement incomes.<sup>216</sup>

Indeed, this kind of computer trading itself may have made the stock market more volatile, and stock prices more artificial, rising and falling on

costs of the Chilean system by 1999 were close to 25%. Jorge Bravo & Andras Uthoff, *Transitional Fiscal Costs and Demographic Factors in Shifting From Unfunded to Funded Pension in Latin America*, U.N. Doc. LC/L 1264-P, U.N. sales No. E.99.II.G.38, at 5 (1999). The study also examined the transitional costs involved in shifting from unfunded to funded pension systems in Latin America, essentially in the Chilean model, and concluded that "in several countries, especially those with more aged populations and high coverage systems, the pension debt is very high, and that a switch from unfunded to fully funded systems implies substantial fiscal costs, that may even turn out to be economically and politically unviable . . ." *Id.*

214. *Retirement Security Policy, Proposals to Preserve and Protect Social Security*, Hearing Before the Senate Comm. on Finance, 105th Cong. 50 (1998) (statement of Edward Gramlich) (proposing that "[u]nlike the other two plans proposed in the Advisory Council report, there would be no reliance at all on the stock market to finance Social Security benefits, and no worsening of the finances of the Health Insurance Trust Fund").

215. For example, in one article, Senator Don Nickles highlighted the advantages of individual management of retirement accounts:

Today, Americans are increasingly aware of the need for long-term financial planning and are capable of handling their own investments. Indeed, surveys show that Americans are already investing in the private market and becoming better educated about how it works. . . . The statistics show that Americans are indeed smart enough to invest for themselves. Moreover, they want to have ownership over their own futures.

Senator Don Nickles, *Policy Essay: Retiring in America: Why the United States Needs a New Kind of Social Security for the New Millennium*, 36 HARV. J. ON LEGIS. 77, 106-08 (1999).

216. Deborah McGregor, *Levitt Warns Inquiry of Risks in Day Trading*, FIN. TIMES (London), Sept. 17, 1999, at Americas 6 (reporting that "Arthur Levitt, [then] chairman of the U.S. Securities and Exchange Commission (SEC), told a congressional panel that investors were being swayed by misleading claims of riches to be won, when in fact day traders were far more likely to lose their shirts"); see also Tom Walker, *If You Love to Play the Market, Take This Test - You May Have a Problem*, ATLANTA J. & CONST., Jan. 13, 1994, at F3 ("Many aggressive investors are really gamblers in disguise," says Financial World in its Jan. 18 issue. The magazine offers a 10-point questionnaire designed to reveal a person's gambling tendency.").

rumors or that elusive measure "consumer confidence" without any corresponding changes in company earnings or future prospects.<sup>217</sup> According to Robert Shiller of Yale:

The high recent valuations in the stock market have come about for no good reasons. The market level does not, as so many imagine, represent the consensus judgment of experts who have carefully weighed the long-term evidence. The market is high because of the combined effect of indifferent thinking by millions of people, very few of whom feel the need to perform careful research on the long-term investment value of the aggregate stock market, and who are motivated substantially by their own emotions, random attentions, and perceptions of conventional wisdom. Their all-too-human behavior is heavily influenced by news media that are interested in attracting viewers or readers, with limited incentive to discipline their readers with the type of quantitative analysis that might give them a correct impression of the aggregate stock market level.<sup>218</sup>

Of course, Shiller wrote these words before the decline of the market beginning in early 2000, which has resulted in a 15-20% drop in overall market share prices. In a bear market, the shortcomings of a retirement system relying solely on individual savings and investments are more glaringly apparent.

The dangers of a completely equity-based retirement system have been illustrated in stark fashion by the plight of employees of the Enron corporation, whose retirement plan consisted solely of a 401(k) cash or deferred plan invested largely in Enron stock which became worthless upon Enron's declaration of bankruptcy. While some of these employee's accounts could have been partially salvaged by more diverse investment holdings, their reliance on the advice of their employer and of investment analysts generally who continued to advise buying Enron stock well into the year 2001 demonstrates the high risk of private investing for most workers. In the wake of accounting and investment advising scandals accompanying the Enron debacle, it seems clear that even well-advised and informed investors can easily be misled into bad investments by those same advisors.<sup>219</sup>

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217. David Barboza, *N.A.S.D. Chief Cautions Firms about the Internet Trading Risks*, N.Y. TIMES, Feb. 10, 1999, at C9 (noting National Association of Securities Dealers's (N.A.S.D.) increased scrutiny of day traders, suggesting that day traders are creating volatile and risky markets).

218. ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 203 (2000).

219. The Enron bankruptcy has, of course, prompted a flood of articles that will only increase over the coming months. For reporting and commentary on the 401(k) problems of Enron employees, see generally Robert Luke, *401(k) Plans Embraced: Workers Still Want Company Stock Despite Enron Fall*, ATL. J. & CONST., Feb. 1, 2002, at C1; Richard Stevenson & Stephen Labaton, *Bush to Propose More Flexibility on 401(k) Plans*, N.Y. TIMES, Feb. 1, 2002, at A1. For an analysis of how the Enron bankruptcy should inform the Social Security privatization debate, see Paul Krugman, Editorial, *A Defining Issue*, N.Y. TIMES, Dec. 4, 2001, at A20.

A second "leakage" problem in a newly privatized social security system would be the possibility of access to the funds in an account either before retirement or during retirement in a way that would endanger the life-time income stream necessary to support the individual until death. Most, but not all, privatization advocates eschew the concept of mandatory annuitization.<sup>220</sup> Moreover, there would be practical problems if the system used private insurers to underwrite the annuity contracts, as some have proposed: annuitization of small accounts would be costly, insurance companies are not likely to issue indexed annuities, and participants would be at risk of insurer insolvency, which opponents would use as an argument against privatization.<sup>221</sup>

If we were to implement a private account regime with safeguards against leakage, political pressures still ultimately might push the system to a different design. In the private system, employees may withdraw funds from 401(k) plans in some circumstances, and there is no excise tax on pre-retirement withdrawals from plans and individual retirement accounts when employees make withdrawals for certain approved purposes. The pressures that produced these leaks in the private pension system may well result in similar leaks from a privatized social security system, in which people have accounts to which they contribute and thus may have a sense that they should be able to access that money, at least in emergencies.

Similar pressures would push for modification of any initial rule requiring annuitization. Moreover, societal and political sympathy might be particularly high in cases when people have strong need for access to their accounts, such as sickness or purchasing a home. Any carveout for special purposes would also impose an administrative cost on the system to determine eligibility for an exception.

In addition, the design of a mandatory annuitization – whether structured around the private insurance market, a governmental insurance provider, or some combination – may lead to participant dissatisfaction and consequent political pressure to drop required annuitization. If the private insurance market is the exclusive structure for providing annuities, annuities will likely vary dramatically depending on interest rates at the time of annuitization. Pensioners disadvantaged by this and who see similarly situated individuals

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220. For example, Senator Nickles clearly sees advantages in worker ownership of a lump sum result of investment performance, whose payout would not be connected to longevity and which workers could pass along to heirs. Nickles, *supra* note 215, at 98-99.

221. Annuitization would likely also add even more costs to an individual account system. For example, in discussing the charges for converting fund balances into annuities, Thompson notes, "Individual choice comes at a cost, however. A recent analysis of annuity charges in the United States suggests that a 65-year old male should expect to pay the equivalent of roughly 20 percent of the value in his account to convert the lump sum into an annuity." THOMPSON, *supra* note 212, at 6.

receiving larger annuities are likely to feel cheated by the system. Insurance companies issuing annuities have much higher administrative costs than the Social Security system, and those costs will be a drag on benefits. Even if a captive market results in a lowering of annuity load factors among private insurers, the necessity of having two systems will impose additional costs, which will lower benefits. It is also possible that insurers will not want to annuitize small account balances, leading to political pressure to limit annuitization options for such individuals. If the government moved in as insurer of last resort for those with small account balances, the annuitization factors may be different, and less favorable, for those with small accounts.

A purely governmental annuitization program might also engender political pressures to opt out of the system. If the government had to annuitize with a single conversion rate, individuals with large account balances, long life expectancies, and consumer savvy might argue that the rules should permit them to use a private insurer if they can secure more favorable annuitization rates. Such pressure might lead to insurers underwriting the best risks and increasing costs for the governmental program. Participants left in the governmental program, faced with higher annuitization rates, might argue that the rules should permit them to opt out of annuitization. One might expect similar results if the initial design of the system contained governmental and private components. Thus, there is a substantial risk that even if the initial system design required annuitization, the concept of mandatory annuitization might erode over time.

Governmental participation in an annuitization program would also create possible public finance issues. If interest rates fall, the government – unless it purchased secure long-term debt instruments, which might include purchasing such instruments from itself – would assume an insurance risk that it may ultimately have to finance out of public revenues. If interest rates rise and the system shows a surplus, there might be pressure from participants to provide upward adjustments to benefits and pressure from other political actors to allow government to dip into the "surplus" for other programs.

Thus, developing a program of private accounts within the Social Security system carries with it the possibility of introducing leakage into the Social Security retirement program. Indeed, one of the strongest attractions of privatization appears to be the accumulation and inheritance of wealth possible in a personal account system, in contrast to the income maintenance without estate building that is an essential feature of social insurance systems generally. The risk of either losing the amounts in such accounts or expending the savings on non-retirement income purposes may to many Americans be worth the possibility of disproportionate gain through investment of an individual account. The problem is that the risk is much higher for those who have the fewest additional resources to support them in old age.

### *C. Linkage or Failures of Expectation*

The final gap in the private pension system that the current structure of Social Security most effectively fills is the problem of expectation of income security in old age. Most people will not risk stopping work while they are still physically and mentally able if they are not sure they have enough income to support them until death. This idea of linkage, the link between an employee's expectations about private sector benefits and the ultimate realization of those benefits, is critical to the employee's ability to formulate reliable financial plans for retirement. Yet the private sector retirement system is one in which employee expectations and reality often lack linkage. Moreover, because private systems depend on voluntary employer participation and employer flexibility, the problems of insufficient guarantees have no easy solution short of fundamental redesign of the systems.

An intermediate solution may be to require more candid disclosure about rights retained by employers to alter benefit programs and about how that may affect employees. This solution, however, may alter, but would not increase, the degree of certainty in the system because rational employees would assume that employers would modify benefits to the detriment of employees at a point when it was too late to make alternative arrangements. Ultimate payment of benefits would then become a windfall to employees who have made alternate arrangements.

This Article also suggests that the shift to an increasingly defined contribution world has created further problems of uncertainty that, at least compared to the world of defined benefit plans, compromise the ability of employees to accurately assess their income in retirement, which, in turn, depends on assumptions about future rates of return, life expectancy, and interest rates (or annuity purchase rates). The Social Security system, which historically has provided a strong measure of certainty, provides a counterweight to this instability of employee expectations in the private pension system. In particular, the dual system of indexing provides certainty that benefits themselves are likely at least to maintain an immediate pre-retirement standard of living.

Perhaps more important, the fact that the political will of the American people underwrites the Social Security system and that the taxing and spending power of the federal government supports it makes this public retirement system an almost absolute source of certainty in retirement income for the elderly. Converting the system to one of private accounts will necessarily undermine that certainty, particularly if the system does not require mandatory annuitization of benefits.

First, as discussed above, the Social Security system bases its benefit structure on wage indexing of the earnings records that determine initial retirement benefits as well as on price indexing of benefits in pay status (the cost of living increases or "COLAs"). Thus, the initial benefit more accu-

rately reflects increases in productivity over the worker's lifetime and guarantees retirees a share of the national increase in standards of living through their Social Security benefits.<sup>222</sup> Once benefits begin, the system indexes them to price increases, thus ensuring that retirees' incomes, at least to some extent, keep pace with their consumption needs.

In contrast to these virtual certainties, a private account system may or may not adequately reflect productivity increases before retirement – returns on investments depend on individual stock performance or on interest rates, which a number of random factors having little to do with overall economic productivity may affect.<sup>223</sup> Similarly, after retirement, unless the participant used the account proceeds to purchase an inflation-adjusted annuity, it would be very difficult for an individual retiree to know for certain whether an accumulated amount would be sufficient to support her consumption needs until death. Moreover, retirees must liquidate account balances invested in most types of equity, such as stocks or real estate, to provide cash for direct consumption. As a result, retirees would face a series of timing decisions (if, that is, there were no requirement that they buy life annuities immediately at retirement) concerning total or partial liquidation of their portfolios, decisions which could be beneficial or disastrous depending on circumstances largely out of the individual's control or predictive capacity.<sup>224</sup>

The other linkage or expectation issue is the perhaps more basic one of receipt of any benefits at all. Proponents for privatization of Social Security frequently argue that the certainty of individual ownership of an account is a principal advantage of a private account system, and they contrast the value of private ownership with the uncertainty they see in a program subject to the political system, a program that Congress theoretically can change on a whim.<sup>225</sup>

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222. The importance of the wage-indexed benefit formula is highlighted by the recommendation of the President's Social Security Commission to replace it with price indexing, as a way to reduce all future benefits under Social Security. See Report, *supra* note 1, at 12-13, 71-72. For an analysis of the effect of changing to price-indexing on benefit levels, see KILOLO KIJAZI & ROBERT GREENSTEIN, REPLACING 'WAGE INDEXING' WITH 'PRICE INDEXING' WOULD RESULT IN DEEP REDUCTIONS OVER TIME IN SOCIAL SECURITY BENEFITS (Ctr. on Budget & Policy Priorities Report, Dec. 14, 2002), at <http://www.cbpp.org/12-10-01socsec.htm>.

223. See generally SHILLER, *supra* note 218.

224. A recent personal experience of one of the authors illustrates this problem. One elderly parent with increasing levels of dementia required admittance to an assisted living facility, which required a large up-front fee as well as sizeable monthly payments. The other elderly parent, also in poor health, faced the prospect of having to finance this expense by either liquidating a stock portfolio that had lost 30% of its value in the last eighteen months (since the beginning of 2000) or selling the couple's home, thereby endangering her own financial security in the future. In the end, the parent never had to make the choice, but the dilemma illustrates the problems of basing old age financial security solely on the value of accumulated equity portfolios.

225. See, e.g., *Matthews v. Eldridge*, 424 U.S. 319 (1976) (holding that due process does not require evidentiary hearing prior to termination of disability benefits).

However, the contrast between the certainty granted by private ownership and the uncertainty of the political process in this case may be more illusory than real.

Since its enactment in 1935, the Social Security system has undergone many changes, primarily expansions, but also some limited examples of retrenchment. Most notably, in 1977, Congress made a correction in the automatic indexing formula and then, in the 1981-1983 budget and refinancing bills, addressed the short-term financial difficulty the program was then in and achieved some savings in the federal unified budget.<sup>226</sup>

The most notable characteristic of the changes made to decrease Social Security expenditures, however, is that only one – a six month delay in the COLA in 1984 enacted as part of the 1983 refinancing bill – affected current beneficiaries. All of the other types of cutbacks affected future beneficiaries – that is, those not yet eligible to receive benefits.<sup>227</sup> Thus, one immediate conclusion might be that unlike the stock market, which can deplete a retiree's portfolio in a week or even overnight, the political system is extremely loath to touch current benefits in any way except to provide an increase.

Second, since the changes made in 1983, there have been no real changes in benefits promised to future recipients, let alone to current beneficiaries.<sup>228</sup> This record is not unexpected given the growing numbers of voters at or nearing retirement age and the looming baby boom generation rapidly closing in on age sixty-five. It is somewhat surprising, though, that so many advocates of privatization would be willing to trade a system over which the public has substantial policy control, through its vote, for one based solely on investment performance, thus placing retirement in the lap of an institution, the stock market, over which no one has any control. This skepticism about the power of the public to work its will to maintain Social Security through the political process may speak more to a generalized hostility to, and doubt about, the efficacy of government programs generally than about specific weakness in the public retirement system.

## VI. Conclusion

The private pension system, at its best, is a robust, creative system that provides substantial retirement benefits to many American workers. The sys-

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226. See Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (implementing progressive increase in retirement age and eligibility); Social Security Amendments of 1977, Pub. L. No. 95-216, 91 Stat. 1509 (modifying indexation formula).

227. See Social Security Amendments of 1983, §§ 101-02 (expanding coverage); *id.* § 111 (delaying cost-of-living adjustment for 1983); *id.* §§ 121-25 (regulating taxation of Social Security benefits in future and accelerating scheduled tax increases).

228. The only significant Social Security legislation enacted in the last ten years was to make the Social Security Administration an independent agency, outside of the Department of Health and Human Services.

tem, however, is a voluntary one and employers design the particulars subject to statutory minimum standards. Those minimum standards, as noted in this Article, leave much flexibility to employers as to which employees will accrue and ultimately earn benefits, what those benefits will be, whether those benefits will change or terminate in the future, and whether employees can tap into their benefits prior to retirement. There are advocates for reducing this flexibility, for heightening benefit certainty, for increasing equity in the distribution of the tax subsidy for low- and moderate-income workers, and for reducing the amount of leakage from the system. Nonetheless, the business community, and to some extent organized labor, view flexibility to shape and modify plan design as an essential component of the private pension system, which may mean that political obstacles will interfere with attempts to increase regulatory standards for retirement plans. Indeed, Congress has recently reduced regulatory influence on the design of retirement plans.

One of the likely outcomes of this new congressional direction is a diminution of private sector retirement benefits for low- and moderate-income workers. This Article has argued that a privatized Social Security system involving individual investment accounts has potential to reduce Social Security benefits for this same group of employees.

The Social Security system also provides a type of feature diversification to our nation's overall retirement portfolio. The private system's robustness may well require shielding employer flexibility from comprehensive government regulation to protect employee expectation and to ensure preservation of pension assets for retirement. The Social Security system, with its fixed and certain defined benefits payable over the course of a wage earner's retirement, is a significant counterweight to the weaknesses of the private pension system. Adopting a system of private accounts would introduce many of the private pension system's most glaring weaknesses into the parallel public system. This suggests that caution should mark political discourse on the desirability of private Social Security accounts.

If private accounts are to become part of the system, the design of those accounts should take into consideration the need for predictability in benefits and should safeguard against leakage. This would virtually require annuitization of account balances, and the system should index annuities to increases in the cost of living. Moreover, the design of the annuitization mechanism should anticipate potential problems that might create future political pressure to relax mandatory annuitization.

Similarly, it would not be adequate for legislation creating private accounts to bar pre-retirement access to assets. It should also recognize the possibility of evolving pressures to permit such access in the future. This may involve erecting super-majority requirements to amend a private account system to permit pre-retirement access. Of course, if all of these features were part of a private account system, it would look remarkably like the current



Social Security program in many ways, thus raising the important issue of whether we should bother to make such a change to start with.

In 1987, Professor Michael Graetz argued that our polity should conceptualize a coherent and unified retirement policy, which begins with the recognition that Social Security provides inadequate benefits for all income classes and that the private pension system heavily favors the wealthy.<sup>229</sup> At the time that Professor Graetz was writing, he observed that Congress in 1986 was "willing to go quite far in an effort to ensure some distribution of benefits to low- and moderate-income earners."<sup>230</sup> This Article suggests that agency-initiated regulatory changes have pushed in the opposite direction and that in the last decade Congress itself has reversed direction, increasing benefits for the affluent and reducing regulatory requirements designed to ensure a meaningful level of benefit distribution to others.

At the start of a new century, we still compartmentalize our retirement policy by separate consideration of the private and public retirement systems. As a result, our President and Congress see Social Security as a system in financial crisis, perhaps requiring radical surgery – private investment accounts financed through cuts in the guaranteed benefit – that will reduce the flow of retirement income to the most needy elderly as well as to low- and moderate-income retirees generally. At the same time, Congress enacted, and the President signed, legislation that commits tens of billions of new dollars of tax subsidy to a system that primarily finances retirement benefits for America's most affluent citizens. If we viewed the private and public systems as components of a single retirement policy and if we understood that the ideal of using leverage to ensure some benefit distribution toward low- and moderate-income workers in private sector retirement plans has never worked well and is disappearing, Social Security reform might focus on improving benefits for those who will not benefit from the publicly supported private-sector pension system and not merely on shoring up its finances.

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229. Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 879, 907 (1987).

230. *Id.* at 907.

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