

Pension Plans and Public Policy

Harry P. Kamen

Gerard J. Talbot

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BOOK REVIEW

Pension Plans and Public Policy. WILLIAM C. GREENOUGH & FRANCIS P. KING. New York: Columbia University Press. 1976. Pp. xi, 311. \$15.00.

Impending financial doom in New York City has been averted several times through massive loans from city workers' pension funds.¹ Such loans, if made by private employer pension funds, might well have been illegal.² Yet there has been no public outcry from the workers whose pensions are threatened, presumably because the action taken is considered necessary to preserve their jobs. Nor has the public voiced any protest, perhaps because a good share of the responsibility for the debacle can be attributed to the unions' extraction of generous pension benefits.

In part, the lesson to be learned by the rest of the nation from the financial crisis of its principal city is the need for pension planning. The impediment to absorbing that lesson is ignorance—an ignorance of the concepts, operations, benefits, and costs of pension plans that afflicts both political leaders³ and the general public. Such ignorance is not surprising, since the facts are complex, the issues are not immediate, and the basic vocabulary of pension plans is itself intimidating. But the tremendous expansion of Social Security and private and public pensions, and the accumulation of huge pension reserves, make sound social and economic planning for the United States impossible without an understanding of the role and effects of pension planning.

In *Pension Plans and Public Policy*, William Greenough and Francis King attempt to dispel this ignorance. They clearly and simply present basic concepts, thoroughly explain the structure, costs, and benefits of pension plans, and give balanced consideration to public policy analyses and proposals. Although the ex-

¹ See, e.g., Raskin, *Pension Trustees Juggling Inherent Interest Conflicts*, N.Y. Times, Mar. 16, 1977, at D1, col. 3.

² See Employee Retirement Income Security Act of 1974, §§ 404(a)(1)(B)-(C), 407(a), 29 U.S.C. §§ 1104(a)(1)(B)-(C), 1107(a) (Supp. V 1975).

³ "Former Secretary of Commerce Peter G. Peterson, who headed a private commission on federal salaries last year, said he was struck by the number of House and Senate members who 'are unaware of these huge future pension costs.'" *Journal of Commerce*, Feb. 24, 1977, at 2, col. 4.

planatory sections are designed primarily for the nonprofessional, the policy recommendations deserve the attention of all interested citizens, experts and laymen alike.

The three major components of the American pension system analyzed by Greenough and King are Social Security, private pensions, and public employee pensions.

I

SOCIAL SECURITY

Social Security is the foundation of the American retirement system, covering more than ninety percent of our workers. It is the sole support of many retirees, while for others it provides a base to which private or public pension benefits, or personal savings, are added for a comfortable retirement income.

Although the amount of Social Security benefits received depends on the worker's pre-retirement income, the funds used to pay those benefits are provided by current taxes. Thus, the Social Security taxes paid by a worker and his employer are not set aside, invested, and accumulated to provide for his own retirement. Rather, they are used currently to pay benefits to workers who have already retired.⁴

Under the existing Social Security system, there are about three workers for each retired person receiving benefits.⁵ Demographic factors indicate that by the year 2030 this ratio will have declined to about two workers for each retiree.⁶ Taxes on both the employer and the employee will thus have to rise by approximately fifty percent merely to provide the same level of benefits. Under

⁴ An increase in wages provides workers with some degree of protection against inflation. This protection is not available to retired persons. To counter the effects of inflation, Congress amended the Social Security Act in 1972 to trigger automatic increases in benefits with rises in the consumer price index. See Act of July 1, 1972, Pub. L. No. 92-336, § 202(a)(1), 86 Stat. 406 (codified at 42 U.S.C. § 415(i) (Supp. V 1975)). However, the 1972 amendment coupled the current workers' entitlement formula as well as the retired workers' benefit formula to the consumer price index, with results that were as unintended as they are dramatic. For example, a worker entering employment today, who receives 5% annual wage increases until retirement in 2025, would retire with a pension of 130% of his final salary, if inflation during this period were 4% per year. On the other hand, if the inflation rate were 2%, he would receive a pension of only 49% of his final salary. That such a senseless disparity remains uncorrected illustrates the complexity of the subject. See pp. 100-03.

⁵ P. 97.

⁶ *Id.*

these circumstances, it is doubtful whether the workers of 2030 will look with favor upon the Social Security system.

Greenough and King offer as a possible solution the extension of the normal retirement age to sixty-eight.⁷ This would increase the size of the working population as compared with the population of retired persons. The effect on each worker would be to extend the period during which Social Security taxes must be paid, defer the receipt of benefits, and reduce the period during which benefits are provided.

The arithmetic is sound, but what about the sociology? The authors speculate on the advantages of a longer work life, but the trend in public preferences seems to be toward earlier retirement.⁸ Further study is needed on this question, but economic and political realities may necessitate the postponement of retirement as succeeding generations of workers object to paying the steeply increasing taxes required to maintain the present system.

II

PRIVATE EMPLOYER PENSION PLANS

Private pension plans cover approximately half of the workers employed in the private sector.⁹ The dominant recent development in this area was the enactment of the Employee Retirement Income Security Act of 1974 (ERISA),¹⁰ which marks a shift in public policy from a tax-based orientation to direct government regulation of private pension planning and operations. Perhaps because this program is still in its early stages, Greenough and King do not deal with some of the potentially serious problems that have already surfaced.

For example, in discussing the investment of pension plan funds, the authors advocate a broader dispersal of investments, which could benefit the capital needs of small businesses.¹¹ ERISA's fiduciary responsibility provisions, however, have caused many managers of pension plan funds to adopt a conservative investment philosophy, resulting in reduced investment in common

⁷ P. 104.

⁸ Pp. 223-26.

⁹ P. 109.

¹⁰ Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified in scattered sections of 5, 18, 26, 29, 31, 42 U.S.C.).

¹¹ Pp. 149-52.

stock and other risk investments and greater reliance on high-quality fixed-income securities. Because portfolio managers face an increased threat of personal liability under ERISA, it is unlikely that pension plan funds will provide a major source of venture capital for small and growing businesses.

In discussing the vesting of pension benefits, the authors acknowledge the importance of ERISA's vesting provisions, but view them as only the first step toward the long-range goal of full and immediate vesting.¹² Since the enactment of ERISA, however, the number of new pension plans established in the United States has declined significantly, and terminations of existing plans have been more numerous than anticipated. To what extent this adverse experience is attributable to ERISA's vesting, participation, funding, and other cost-increasing requirements is currently the subject of considerable dispute. Some argue that the recent economic recession has been the major contributing cause, and that in any case many plans were properly terminated because they were inadequately funded. Nevertheless, any further liberalization of ERISA's vesting and other requirements should await the results of studies investigating whether ERISA has had the unintended, undesirable effect of restricting the growth of private pension plans.

An important policy proposal, not mentioned by the authors, would change federal income tax law to provide for limited deductibility of employee contributions to employer pension plans. Such a provision could result in a substantial increase in pension plan funding and benefits. Congress recently took a small step in this direction by providing that employees not covered by an employer pension plan could establish their own tax-deductible plans, known as individual retirement accounts or annuities.¹³ Extending this tax-deductible treatment to cover employee contributions to the *employer's* pension plan is the logical next step.

Our one basic disagreement with the Greenough and King analysis of private pension plans relates to their comparative evaluation of the two basic types of private plans. The two plans differ in their initial focus: the defined contribution plan focuses on the sums to be set aside during the worker's career, while the defined benefit plan focuses on the sums to be paid out after retirement.

¹² Pp. 153-55.

¹³ See I.R.C. §§ 219, 408 (added by Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002(a)(1),(b), 88 Stat. 829); I.R.C. § 220 (added by Tax Reform Act of 1976, Pub. L. No. 94-455, § 1501(a), 90 Stat. 1520).

Under the defined contribution plan, a stated percentage of salary is contributed regularly to the plan until retirement, when a pension is provided on the basis of whatever sum has accumulated. Under the defined benefit plan, a stated percentage of salary (usually calculated on a final-years'-average basis) is paid out as a pension after retirement, with annual contributions to the plan fixed at whatever level is necessary for the orderly accumulation of a fund sufficient to provide the pension.

Of course, the percentage of salary to be contributed each year under a defined contribution plan can be derived by calculating the desired pension as a percentage of the worker's salary during his final years of employment, making assumptions as to the interest to be earned on the accumulating funds. Unfortunately, this type of plan is subject to the risk that if the interest earnings prove to be lower than predicted, or if there are unexpected increases in salary toward retirement, the targeted pension will not be achieved. The chief virtue of the plan is its essential simplicity, allowing the employee at every point to calculate the amount accumulated in his account. It also has the advantage that a worker may leave one job to enter another with a similar type of plan without endangering his final pension, if his benefits have been vested along the way.

In contrast, under the defined benefit plan, contributions to the plan are determined according to various actuarial formulae, with the objective of accumulating a fund sufficient to pay exactly the prescribed benefit—for example, sixty percent of the worker's average salary during his last five years of employment. This type of plan has the advantage that, despite any errors in the interest projections and any changes in salary structure, the plan remains obligated to pay the predetermined benefit. Thus, the plan—rather than the participant—bears investment and inflation risks. The comparative disadvantage of the defined benefit plan, however, is that the sums accumulated for a particular worker at any time prior to retirement are likely to be less than those accumulated under the defined contribution plan. Thus, a worker who frequently changes jobs under roughly equivalent plans, may receive a greater benefit under the defined contribution plan.

Pleading the justification that defined contribution plans "are not usually covered adequately in pension literature,"¹⁴ the authors depart from their well-balanced approach in other areas to emphasize the advantages of the defined contribution plan while

¹⁴ P. 176.

generally ignoring its detriments. Conversely, they underscore the drawbacks of the defined benefit plan while largely ignoring its advantages.¹⁵

Clearly, the retiring worker's primary concern is the amount he will receive as a pension, and not the method used to accumulate the necessary funds. A worker retiring today, whose salary was fairly stable over a long period of time but which increased dramatically with the last decade's inflation, will receive under a defined benefit plan a pension based on those last few years of inflation-adjusted salary. Under a defined contribution plan, however, that same worker would have had larger yearly contributions added to his account during the last few years of employment, but would receive a pension that does not represent as high a percentage of his final salary.

The choice between these two basic types of plans, and their variations, will usually rest on a determination as to which is better suited to industry characteristics, particular types of businesses, and employee characteristics within a particular firm. Owners of small businesses, for example, will tend to favor the defined benefit plan, which meets the needs of older employees, usually including the owners, for whom there is insufficient time to build up an adequate fund under a defined contribution plan. Thus it is simplistic to characterize one type of plan as clearly superior to the other.

III

GOVERNMENT EMPLOYER PENSION PLANS

Like so many other American institutions, our retirement system represents a compromise that works well but not perfectly. An attempt to make the system perfect would probably destroy it, but allowing it to run its present course would probably destroy it as well. The greatest danger lies in the governmental segments of the system. Proliferating government pension promises have in many cases outstripped the capacity of taxpayers to bear their cost.¹⁶ There is nothing wrong with providing generous benefits to employees, public or private. But someone must pay for them. The public pays for a large part of increased benefits in private plans

¹⁵ See pp. 182-89.

¹⁶ Of course, these commitments were compounded by the 1972 amendments to the Social Security Act. See note 4 *supra*.

through higher prices. These are normally subject to the restraints of competitive forces and the willingness of the public to pay. Government, on the other hand, has little or no competition for its services, and the public has little freedom in choosing whether to pay its taxes.

The financial troubles of the nation's largest city recently focused attention on New York's unusually generous state and city pension plans. Greenough and King point out, however, that the plans of many other states and municipalities are even more drastically underfunded than New York's, while all of these pale in comparison to the underfunding of federal employee pension plans, where the assets fall short of incurred liabilities by close to \$300 billion.¹⁷ What all this means, apart from an occasional municipal bankruptcy, is that future generations of taxpayers will have to bear enormous burdens created by legislators they did not elect. Add the coupling effect of the 1972 Social Security amendments¹⁸ to the large number of overly generous public retirement systems, stir in some demographic factors, and you have the prescription for a gigantic social disaster sometime between thirty-five and fifty years from now. If this seems too far off to worry about, consider that persons now entering the work force will expect to live on their retirement income at just about that time.

One possible solution may be the creation of a brother for ERISA, named GERISA—a Government Employees Retirement Income Security Act. Greenough and King carefully and convincingly set forth the public policy to be implemented in this area.¹⁹ If Congress sets its own house in order, lawyers may be confronted with the as-yet-unmentioned but intriguing question of whether Congress possesses the constitutional power to compel states and municipalities to do the same for their own employees.

*Harry P. Kamen**
*Gerard J. Talbot***

¹⁷ See pp. 202-03. This figure assumes a modest 4% inflation rate.

Not only are the funds inadequate, but their investment is hardly calculated to produce a very satisfactory return. While the tax-exempt state pension funds have generally corrected their incredible practice of investing in low yielding tax-exempts (from 25% of assets in 1956 to less than 2% in 1973), the federal civil service retirement system remains invested in lower yielding federal government obligations. See pp. 136, 144.

¹⁸ See note 4 *supra*.

¹⁹ Pp. 203-06.

* Vice-President and Associate General Counsel, Metropolitan Life Insurance Company. A.B. 1954, University of Pennsylvania; LL.B. 1957, Harvard University.

** Vice-President and Tax Counsel, Metropolitan Life Insurance Company. A.B. 1953, LL.B. 1958, Fordham University; LL.M. 1962, New York University.