

Chapter 6.

**PENSIONS**

*The story we are told on pensions says that individuals, not a company or the federal government, should be in charge of their own financial destiny. When companies began to supplant defined-benefit pension plans with defined-contribution plans, allowing employees to make their own investment decisions, it was a step in the right direction. The story says that Social Security is broken. The younger people are, the less they'll get from it. In the 1980s, retirees got four times what they put into the Social Security trust fund. People who retired in 2000 can expect to get only 1.2 to 1.4 times the contributed amount. Many boomers who retire after 2010 will actually lose money.*

*For anyone under forty, Social Security is a hollow promise. Given the current benefit and tax levels and the increasing number of Social Security recipients, there won't be enough money to pay Social Security pensions at some point. The system isn't stable for the long term. Private investment accounts are the only way to secure young people's retirement. We all know that in the long term the stock market goes up. Just look at all the executives and investors who have made millions in the market. That can happen to the average guy, too. Giving the money to the individual to invest as he or she sees fit is*

## THE AMERICAN RETIREMENT STORY

*important not only for ensuring a more robust Social Security system but for empowering the individual. It is the core of the "ownership society."*

What is wrong with this story?

In America, retirement has become a lifelong goal, the cultural equivalent of paradise in many people's minds. You work hard for years so that you can retire near your grandchildren or move to Florida or Arizona and enjoy yourself. Work gave you the means to take care of your family, and retirement gives you the free time to do what you always wanted to do but couldn't because of the daily demands of work. When you don't like what you do every day, or when the stress becomes too great, or when you like what you do but you're just tired, you dream of retirement.

But to have a comfortable retirement you need income, and retirement income can come from only three sources: your own savings, Social Security, or your company pension. Today none of them is secure.

The unfortunate fact is that most Americans now save very little over a lifetime. Fully 51 percent of Americans own no stocks of any kind. They will depend totally on pensions, and 35 percent of all Americans have no pension other than Social Security. For most of the other 65 percent, private pensions are the key to comfortable retirement.

But when it comes to funding private pensions, not enough money has been put away—either by the companies or by the

## THE NEW AMERICAN STORY

employees themselves. Once people calculate what they need for a secure retirement and compare that with what they have in a pension account, they often find that they come up short, and then it is often too late to realize their financial goals through prudent investing. That's when the stock market gambles start.

There are two kinds of private pensions in America: the defined-benefit pension and the defined-contribution pension. Both are based on the premise that the stock market always goes up in the long run. Both are in trouble.

### **Defined-Benefit Plans**

In a defined-benefit plan, a company agrees to pay an employee a pension that is usually based on the person's ending salary and the number of years of employment with the company. It is a kind of annuity, usually paid monthly for life. The company regularly sets aside money in a fund and has it professionally managed, so that it will grow sufficiently to pay the retirees the promised (and legally binding) amount. In the 1980s, 83 percent of all workers who had a private pension had a defined-benefit plan. In 2003, that proportion was 38 percent.

The defined-benefit plan came about in the early 1940s. It promised pensions that would support a middle-class—not just subsistence—lifestyle. The immediate postwar period was the high point of organized labor; over a third of all workers belonged to a union, and unions demanded generous pensions. Attempts to raise wages had been blocked by federal wage and price controls. When management said the company couldn't

## THE NEW AMERICAN STORY

afford to offer pensions, labor leaders such as Walter Reuther of the United Auto Workers assured the company that the pensions wouldn't put it at a competitive disadvantage because the union would demand the same pensions of all auto companies. It was called the pattern plan. Management went along with generous pensions because, unlike wages, the costs were borne in part by the federal government, in the form of an immediate deduction from company taxes for whatever the company put away for worker pensions, and no tax was assessed on the increase over the years in the pension fund's value.

In such a world, pensions for autoworkers, steelworkers, and other industrial union workers became very generous. Then came the foreign competitors, who had no such pension obligations. They paid lower wages, and their products were just as good as those of American manufacture. When labor lost its monopoly, the pensions became a gigantic and unsustainable cost to the American companies struggling to survive in a global market. As a result, many employees who thought their golden years would be secure—and who had agreed to lower wages over the years because they had been promised generous pensions—found the companies' promises empty. There wasn't enough money in the funds to pay their pensions.

That's when millions of American workers realized that jobs aren't forever and that the absence of economic security can be a daily reality; indeed, the pace of change was disorienting. If you worked for an airline or steel company, an auto company or one of its parts suppliers, a manufacturer of telecommunications equipment or consumer electronics, you lived through a time

THE NEW AMERICAN STORY

when the bottom fell out from under your world.

Most men who worked in the steel plants of Gary and South Chicago thought they had lifetime financial security. So did autoworkers, and so did men and women who worked for Western Electric. They had good unions that got them good wages, health care, and a pension. Today the jobs are gone, the health care is often lost, and the pensions are in danger, too. It didn't happen suddenly, like a bomb exploding; it was a gradual erosion—so gradual that most people couldn't see it happening until it was too late for them to do anything about it.

Suppose you're a man who worked a lifetime with your hands. It takes a toll on you. You get older sooner standing next to a blast furnace or on the assembly line. There is no time to exercise, and your diet is probably full of all the wrong things. Still, you go on. You go to work each day because you're proud of what you do. You like the camaraderie. You sleep well at night, knowing that you've taken care of your family. You send your kids to college, even though you never finished high school. You take care of your wife and occasionally help some in-laws with a loan that never seems to get repaid. You go to church each Sunday, and you put a little in the collection plate, because your job enables you to give thanks to God in this tangible way.

You've been retired now for ten years. You're near seventy-five and beginning to get frail. You get Social Security and Medicare, and you have a good company pension. Then one day you wake up to read in the paper that your parent company has gone bankrupt. It couldn't compete with the Japanese, or the Brazilians, or the Russians, or the Chinese. Two thousand people

have been laid off, which you think is a damn shame. Eight paragraphs further into the story, it says that the company can't pay its pensions, and the government will have to take them over. The next paragraph says that the Pension Benefit Guaranty Corporation will probably pay only 30 percent of the agreed pension. It doesn't have enough resources to pay 100 percent of what you were promised. You look in the mirror and realize that your life has just collapsed. You're too old to go back to work, even if the jobs had not disappeared. Your savings are meager. So is what you're getting from Social Security. You look at your wife, and you both cry.

That scenario is occurring all over America these days. In 2005, I was on a domestic flight when one of the flight attendants asked if she could speak with me. She thought I was still a U.S. senator, and she wanted me to be aware of the predicament she and her colleagues faced. It turned out that she had worked for the airline for thirty-two years, had given up some of her wages in the last union negotiation, and now her health care insurance required an exorbitant premium and a high copay. The previous fall, the airline had sent her a letter thanking her for her years of service and then dropped the bombshell: If she did not retire by January 1, she would lose her pension. Because she needed the wages and hadn't yet become eligible for Medicare, she had had to continue working past the deadline. Thirty-two years had just gone down the drain.

After the passage in 1974 of ERISA, the Employee Retirement Income Security Act, which established legal responsibilities for companies to make good on their pension obligations, it was

## THE NEW AMERICAN STORY

inconceivable that employers would renege on their pension promises. To do so would make them pariahs even in the competitive world of big business. A company made a commitment to its workforce. Companies such as IBM made an explicit connection between employee loyalty and retirement security.

When the late 1990s produced a speculative frenzy in stock prices, companies kept raising their assumptions about estimated returns on their pension fund investments and putting away less and less for their employees. The market was doing it for them. Then the bubble burst, and companies were faced with the consequences. Today many of them have set aside too little money to pay negotiated and promised benefits. The older their workforce, the more serious the problem. These companies have a Hobbesian choice. Either they can set aside more money for pensions and report lower earnings, undoubtedly sending their stock prices lower, or they can continue the fiction of great stock market returns, hoping that investors won't read the fine print in their quarterly earnings reports and short their stock. Some companies, such as General Motors, find their very existence at stake.

When the performance of financial markets is inadequate over a long period of time, neither setting aside more money nor hoping the investing public won't notice is as likely an alternative as simply turning the whole pension liability over to the federal government's Pension Benefit Guaranty Corporation. The PBGC estimates that total underfunding in single- and multi-employer pension funds may be as high as \$600 billion. As more and more

companies turn over their pension liabilities, the resources of the PBGC have become insufficient, and it has insisted that the employees settle for only a fraction of their expected pensions. If many companies default to the PBGC simultaneously, it will be bankrupt, and their employees, along with the 44 million Americans whose pensions the PBGC currently insures (many of whom have worked for forty years in expectation of a legally contracted pension), will have no guarantee that their pension or any part of it will be there for them. Pension resources cannot be built up overnight, and when they turn bad, they cannot be salvaged overnight.

Only the government can back up the private system. To marshal the political support to fix a pension system preemptively becomes a serious political challenge. Even the pension bill that Congress enacted in the summer of 2006 left large areas of pension policy unaddressed. Our slow-motion pension meltdown reminds me of the savings and loan meltdown in the 1980s, when the government ignored the problem until it had become a full-blown disaster.

When it comes to the public pensions of state and local governments, the problems are even bigger. Whereas international competition made transparent the overly generous defined-benefit pension promises of the private sector, the public sector has no such early-warning system. Today the public unions have negotiated pensions so generous that when taxpayers wake up to their ultimate cost, there is going to be an uproar. An airline employee who got twenty cents on the dollar from the PBGC for his bankrupted pension will not be happy



## THE NEW AMERICAN STORY

when he learns he's paying taxes for a public employee's pension so generous it can never be fully paid without raising his taxes even more.

### **Defined-Contribution Plans**

For all these reasons, the story we're told today says, defined-contribution plans, the most prevalent of which is the 401(k), are better than defined-benefit plans. They remove money from "paternalistic" company control and give it to the employee, leaving the choice of investments up to the "self-reliant individual."

As retirement vehicles, defined-contribution plans have numerous problems. First, as Alicia Munnell and Annika Sundén of the Center for Retirement Research at Boston College emphasize in a March 2006 research brief, they are far from being mandatory savings plans. There are too many outs. Employees don't have to participate. Rulings by the IRS in 1998 and 2000 were supposed to help here. They permit employers to offer pension plans that automatically deduct a part of each employee's salary and invest it in a pension fund; any employees who don't want to participate have to opt out, whereas previously employees had to ask to have savings deducted from their salaries. By 2005, only 16.9 percent of all 401(k) plans had put in automatic deductions, and the year before, fully 21 percent of those eligible workers under the plans elected to have no 401(k) deductions. Only 11 percent contributed the maximum, which is usually 6 percent of salary with a 3 percent employer match.

## THE PROBLEMS WITH STOCKS

Among people earning between \$40,000 and \$60,000 annually, the average contribution was less than 1 percent of salary.

The second problem with defined-contribution plans is that most people don't diversify their investments. In 2004, 31.6 percent of all defined-contribution participants held no stocks. Many invested almost solely in money-market funds, which are safe but provide low yields and therefore cannot compound to reach the person's desired retirement nest egg. Twenty-one percent of defined-contribution-plan participants put 80 percent of their funds in equities, with many concentrating too much in their own company stock. They will suffer a double loss if the company falls on hard times. They might lose their jobs and in addition see the value of their pension plan drop precipitously. If you don't believe that can happen, just ask the former employees of Enron and WorldCom.

And a third problem is the practice of cashing out when you change your job. In 2004, 45 percent of those who changed jobs cashed out their 401(k) plans instead of rolling them over into an IRA (individual retirement account). Thus the value of compounding is lost.

Once the company has contributed to the employee's defined-contribution plan, it no longer has legal responsibility for the pension. With a defined-contribution plan, all the risk rests squarely on the shoulders of the employees. It's up to them to decide how to invest the money, which is quite different from defined-benefit plans, in which the workers make no financial decisions before retirement—they simply retire and begin collecting their promised pensions. But most people don't have

THE NEW AMERICAN STORY

the time or savvy to manage their own money. Companies may offer their employees advice on money managers. Occasionally, a union will send its membership a pamphlet outlining the various choices and asking members how they want their money managed. Do they want it invested in foreign or domestic stocks; in bonds or stocks; in high-growth, high-risk stocks; or in value stocks that often pay dividends? If they choose the right options, they will have a good retirement; if they make poor choices, they will have a miserable retirement. There is no certainty. Given that defined-contribution plans have mushroomed over the last twenty-five years—in 1980 only 40 percent of all workers had defined-contribution plans and now it's 90 percent—the collective risk for people with no investment experience is considerable.

One might also argue that these plans are simply tax shelters for the well-off. The typical plan is not an annuity paying a guaranteed amount based on the individual's last salary; instead it is a draw-down system, in which the individual takes lump-sum distributions spread over a period of years. The rest of the money stays in the account, compounding annually, tax-free. The pension experts John Langbein and Bruce Wolk point out in their textbook *Pension and Employee Benefit Law* that if one spouse dies, the surviving spouse can transfer the funds in the 401(k) into an IRA, where they can grow, tax-free, until drawn out during the surviving spouse's retirement. If he or she then converts the IRA into a joint account with the kids, the draw-down can be spread over their lives, too, so that it goes on for decades—long after the original earner is dead. In this respect,

defined-contribution plans do hardly anything for the bottom half of the population, who have little need of such tax shelters. In a February 2006 lecture at the University of Texas in Austin, Langbein observed that these

minimum distribution rules allow a million-dollar defined-contribution account to be paid out across a forty-four-year period, from the participants' first withdrawal at age seventy until the last dollar is paid out to the children. During [that] period, assuming an eight-percent growth rate on investments, the \$1 million generates a total of more than \$11 million in distributions.

Quite a wealth-transfer device! "This is the dirty little secret of the defined-contribution-plan revolution," Langbein said. "Defined-contribution pension plans have ever less to do with pensions and are ever more becoming general-purpose tax shelters for the affluent."

With defined-contribution plans, many people don't get serious about saving until later in life, by which time it is often too late to amass adequate savings for a decent retirement.<sup>\*14</sup> The Federal Reserve's 2004 Survey of Consumer Finances states that if you're a worker between the ages of forty-five and fifty-four, you will need to have put away at least \$169,000 toward your retirement but that the average person in this age category has accumulated only \$49,000. Likewise, if you're between fifty-five and sixty-four, you ought to have \$314,000 set aside, but in

## THE NEW AMERICAN STORY

fact the average person in that age-group has set aside only \$60,000. If the latter group bought an annuity with that money, it would pay them only \$400 a month for the rest of their lives—not exactly an amount that will get them to Florida.

The final problem is that defined-contribution plans are not covered by the Pension Benefit Guaranty Corporation. Millions of people direct the investment of their defined-contribution plans as if the company and/or the federal government stood behind it. They don't. The saddest fact is that most people are totally unaware of the problems attendant on our private pension system. Most assume that their pensions are fine. No one has explicitly told them that the rules have changed, that they're on their own.

Going from defined-benefit to defined-contribution plans means that we give up the certainty of a lifelong pension for the chance to speculate in the financial markets. Corporations win, because they shed responsibility for their employees' pensions. Government wins, because it no longer has to insure pensions under the PBGC. Individuals, by contrast, can lose big. They no longer have certainty, and they might run out of money before they die. Moreover, neither defined-benefit nor defined-contribution plans offer any protection against inflation, and neither makes any attempt to educate the recipient.

### **The Stock Market**

All private pensions are premised on the story line that has pervaded our culture about people who have gotten rich in the

market. Chief executive officers and hedge-fund managers grace the covers of national magazines because they have made hundreds of millions from stock appreciation. Before the 2000 tech-stock crash, college professors drew comfort from the size of their defined-contribution pension funds. Lunchroom conversations among midlevel employees were peppered with stock tips, and even doormen and cabdrivers shared the mania. Now that the market is up again, so is the mania. Hundreds of books and investment letters purport to have the secret of gigantic returns. Infomercials tempt us with surefire ways to make a million in technology, energy, consumer goods, or whatever stock is the flavor of the month. The 1930s, along with the more recent financial downturns, are ancient history. It is this certainty that the stock market is a sure thing over the long run that lends people a false sense of security about their retirement.

I remember the 1987 stock market crash. I heard the news just as I had finished touring cranberry bogs in New Jersey's Pinelands. I sat in the car and listened to the commentator predicting that it was 1929 all over again. As it turned out, the Federal Reserve pumped massive amounts of liquidity into the system and the worst was avoided. Several weeks later, a constituent who had been paying attention to recent events wrote me a letter. "Dear Senator Bradley," it said. "I have a way to guarantee low unemployment, low interest rates, high productivity, low inflation, and high economic growth." Interested, I read on. "Encourage people to invest in the stock market," my correspondent advised, "and if it goes down, have

THE NEW AMERICAN STORY

the government bail them out.”

As George Bush continues to suggest that people manage a part of their own Social Security money, it's worth examining the claim that a permanently rising stock market will come to the rescue of the Social Security system.

Social Security is a government promise—one that we all make on behalf of one another—not an investment strategy. It is all about security, not risk. It says that however your life has gone—whether you've been a construction worker who has only been able to make ends meet or a stockbroker who lost his nest egg through bad stock picks or a homemaker who becomes a widow—all of us together will ensure that you have a subsistence income in your retirement. Social Security has kept many of the elderly out of poverty and remains the sole source of income for millions. About 26 million Social Security recipients get at least half their income from it. If the elderly had to manage their own Social Security dollars and the market crashed, one thing would be certain: They would expect to be made whole, just as my constituent argued. They would petition Congress, and Congress would respond, making up a part of their losses either by raising taxes (the worst thing to do in an economic downturn) or by cutting Social Security benefits so that less government money would go further. The first alternative would be seen by employees as a betrayal of hardworking Americans, and the second would be seen by the elderly as a betrayal of the government's promise to them of a minimal retirement.

What proponents of Social Security privatization ignore is its uneven impact on seniors depending on when they retire. These

proponents point out that the long-term real rate of return on corporate stocks is between 7.0 and 7.5 percent annually. They argue that if “an average income couple”—a couple starting with income of as much as \$20,000 apiece and ending with a \$40,000 income for the husband and a \$30,000 income for the wife—could have diverted their Social Security payroll taxes into an equity account over a forty-two-year period, they would have accumulated \$829,800 at retirement, which would be double what Social Security would pay out and would allow them to buy an annuity that would pay them \$102,000 a year.

Sounds good, if we assume 7 percent growth and all Social Security payments going into equities. But how do we manage the transition? Who pays all those people who’ve been promised a retirement income, if workers suddenly stop transferring their Social Security payroll taxes to the Social Security trust fund and instead invest those amounts for themselves? In 2001, when we had a projected ten-year surplus of \$5.6 trillion, we could have earmarked that surplus for the Social Security trust fund to cover the projected payments to people over a certain age and then allowed the rest of the people to open private accounts. There was never a better time to deal with the transition to private accounts, and Paul O’Neill, Bush II’s first secretary of the treasury and a dedicated and creative public policy thinker, suggested a similar idea to the president. In counselling against a 2002 tax cut, he pointed out that if government used the surplus to give every child \$23,000 on the date of his or her birth, at a cost of \$92 billion per year, and each account got a 6 percent compounded annual return, by retirement those people would



## THE NEW AMERICAN STORY

have a million dollars each. He argued that that was how the surplus should be used, and not for tax cuts. The president scoffed. Aware of the political payoff in tax cuts and the hot-button political sensitivity of Social Security, Bush looked at his political adviser Karl Rove and said, "We *are* in politics, aren't we, Karl?"

Beyond the issue of a feasible transition to private accounts, the volatility in the market poses a problem. While it's true that the market goes up over the long term, it is also true that for long periods the market can be flat or in decline. A look at Standard & Poor's 500 Index tells you that it wasn't until 1953 that the market got back to its 1928 level. The 1968 peak was not seen again until 1972, and it wasn't until 1980 that the index got back to the 1972 level. Investors counting on 7-percent-a-year income growth from 1967 on got much less; those were the years of low stock market advance. If you then retired in 1979, your retirement was much more pinched than that of someone who retired in 1997 and got the benefit of the long bull market.

If people aren't putting away enough in personal savings, and private pensions have exaggerated stock performance over the long term, and Social Security is in trouble, what is the new story about pensions in America?

## THE NEW STORY

The new story asks questions about what it means to be an American. Do we throw all the responsibility for even a minimal retirement back on the individual, no matter his or her education

level? What happens when a lot of individuals lose their money? What do we owe the elderly stranger simply because he or she is a human being? Our decisions about pensions will involve not only how much money people need in retirement but what kind of society we want ours to be.

A good society recognizes its elders for what they have given. It protects them from harm in old age, just as they protected their children. Ideally, all elderly people would have loving, financially stable family members to care for them in old age. Unfortunately, that's not how things always are. The way you judge a society is by how it treats the young and the old. Social Security makes me feel better about myself as an American. The fact that we've found a way to avoid elderly poverty should make us all feel proud. It is an expression of our ultimate sense of community. People should not have to gamble with that achievement for the prospect of doubling their money in the stock market. When retirement comes, seniors deserve certainty. In the new story, they wouldn't have to worry about the stock market's performance.

The new story says that the first thing we owe the elderly (who eventually are all of us) is caring, which is Social Security. The second thing is candor.

There is no free lunch. You can't have comfortable private pensions without setting aside more money in pension accounts over a lifetime, whether that money comes from the individual or the employer. The history of defined-benefit and defined-contribution plans underlines that fact. In the former case, companies under-saved; in the latter, individuals are collectively

THE NEW AMERICAN STORY

failing to put enough money away. Americans need to consume less and save more.

The truth must be told about the stock market. It is a lottery—wonderful but never a sure thing. Investing on their own, millions of individuals will make wrong guesses. Some people will be saving when the market is flat. Swarms of advisers will produce widely disparate results for the people doing the saving. Some will create a herd mentality that could lead people off a cliff. Others will promise returns they know are impossible to deliver. Human nature won't change, especially where money is involved.

What policy choices do we need to make in order to realize this new story in pensions?

In 1982, my fourth year in the Senate, we learned that the Social Security trust fund was about to go broke. A presidential commission was convened. I conducted sixteen Social Security forums across New Jersey with seniors. I had a professor from Rutgers, our state university, describe the problem, and then I put a series of solutions on the blackboard. Conventional wisdom predicted that no one in the room would support cutting benefits. But I discovered that these New Jersey seniors thought as Americans, not just as seniors. They were as concerned about burdening their kids with higher taxes as they were about having their benefits reduced. Because they trusted the information I gave them, and because they wanted to be fair, they agreed in those sessions to reduce benefits, raise taxes, and increase the retirement age. The commission suggested a similar path, and when Congress enacted its recommendations, the life of the trust

## THE NEW AMERICAN STORY

fund was extended for decades. The same thing could happen today.

As I suggested in Chapter 4, four simple steps can be taken to keep Social Security solvent for the next seventy-five years: Raise the minimum eligibility age of sixty-seven years (set to be reached in 2027) by one month every two years until 2099, when it would be seventy years; make 2.0 percent of the 6.5 percent Social Security tax apply to all income, instead of taxing it just up to the current \$94,200 level; bring new state and local government employees into the system over a five-year period; and change the way the cost-of-living increase is calculated, basing it on the chained consumer price index, which accounts for people shifting purchases to cheaper goods when prices go up. Another part of the solution would be to increase economic growth. With more Americans, on average, making higher and higher salaries, more money would come into the trust fund and the system's insolvency date would be extended even further.

The most politically tricky of these changes will be raising the minimum eligibility age to seventy, but real leadership on Social Security means bringing it up-to-date with the work world of today. In 1935, when the system was instituted, many Americans worked in manufacturing jobs, most of which were unhealthy and undoubtedly shortened the natural life span. Now many more Americans work in the service sector (which is arguably safer) than in the manufacturing sector. The average life expectancy in America in 1935 was 61 years (59.9 for men and 63.9 for women). Now the combined average is 78. No social-insurance system can pay current beneficiaries for twenty-plus

THE NEW AMERICAN STORY

years of retirement without raising taxes or cutting benefits. By raising the minimum age of eligibility to seventy, we recognize that life phases are not just work and retirement but include the period from sixty to seventy-five, when many people want to continue working (if perhaps with a reduced load) and not simply for economic reasons. Work enhances vitality and gives life meaning. Fewer and fewer people in their sixties and seventies feel "old." Upping the eligibility age recognizes that new state of affairs and will help to save Social Security. For those Americans in their sixties who have worked at jobs that damaged their health so much they can't work beyond sixty-seven, there should be a narrowly liberalized eligibility for disability until they reach seventy.

With regard to private pensions, it's important to remember that pension obligations are legal obligations, and government should insist that they are respected even if it means bankruptcy and transfer of control of a company's assets to the pension creditors. We need an infusion of cash to bolster the Pension Benefit Guaranty Corporation, which now has a \$60 billion deficit and \$450 billion in unfunded single-employer liabilities. Then we should force corporations to close any shortfalls in their pension funds and make larger contributions to the PBGC. In arriving at its pension obligation, the company should take into account the age of its workforce. The larger the employee group close to retirement, the more the company should contribute to the fund. Companies should stop lump-sum payouts if their pension assets fall below 70 percent of their obligations. Transition to the new system by delaying the date that problem

companies (such as airlines) must comply should not become the first step on the path toward permanent exceptions. As noted, the pension bill that Congress passed in 2006 did not go far enough in protecting employer-based pensions, and Congress hasn't even begun to think about public-pension alternatives should companies find the reform proposals so onerous that they stop offering pensions. While the law beefed up the savers' credit for low-income Americans by \$10 billion, it didn't cover the 50 million Americans who pay no taxes because their income is too low. At the same time, the bill gave \$36 billion to upper-income Americans by raising the amount of money they can put away in their IRAs and 401(k) accounts tax-free.

But we need something beyond employer defined-benefit or defined-contribution plans. Some have suggested a hybrid approach, in which the company guarantees a base amount in a defined-contribution plan, which is managed by professionals selected by the company and insured by the PBGC. While this approach is more flexible, it would be better to match pension liabilities, which are long-term, against assets that are long-term and secure, which means greater investment in fixed-income assets, such as long-term, inflation-proof government bonds. That's the only way to achieve a measure of retirement certainty. Taking bigger and bigger equity risks to pay off overly generous promises or overly optimistic expectations is a recipe for disaster.

We need a retirement system in which all Americans have the same incentives to save. The tax deduction for IRA or 401(k) plans is worth more for the wealthy. A dollar deducted for someone in the 35 percent bracket is worth thirty-five cents in

THE NEW AMERICAN STORY

saved taxes; for someone in the 15 percent bracket, its value is just fifteen cents. Such incentives don't increase savings, they shift them around. The wealthy save anyway and, acting rationally, transfer their assets to the tax-favored savings vehicle. To rectify this upper-income bias, we should eliminate the tax exclusion for IRAs and 401(k) plans while keeping the tax-free accumulation of earnings in those accounts. In place of the deduction, William G. Gale, Jonathan Gruber, and Peter R. Orszag, writing in a white paper prepared for the Hamilton Project of the Brookings Institution, propose a government match of "30 percent for all qualifying contributions up to either 10 percent of adjusted gross income or \$20,000 annually for 401(k) accounts and \$5,000 for IRAs." The cost of this system would be offset by the elimination of the tax exclusion. In other words, for every dollar you save in a 401(k) or IRA, the government will give you thirty cents. The government match would be placed directly into accounts administered by the federal government's Thrift Savings Plan, thereby eliminating the need for more bureaucracy. Or you might make the match into a refundable tax credit that would offset any tax owed by the amount of the credit dollar for dollar, or if there is no tax liability, money would simply be sent to you in the form of a check from the government. You could draw on a limited amount of those federal accounts for health and education purposes, just as you can on current 401(k) plans or IRAs. Such a system might increase overall savings by turning middle-income people who now aren't tempted by a tax deduction worth only fifteen cents into new savers.

A further step to assure retirement security would be to follow up on Paul O'Neill's suggestion to President Bush in 2002: The U.S. government should provide every child born in America a \$5,000 American Birthright grant. It would be put in an account that compounds tax-free and is administered by the Thrift Savings Plan of the federal government. As with state pension funds, the money would be invested in financial instruments such as indexed equity and bond funds. If the funds generated 5 percent annual growth for seventy years, the account would provide a nest egg of about \$152,000 over and above Social Security. If the fund earned 6 percent, the amount would be \$295,000. In that sense, it would be a second tier of federal retirement security.

The U.S. economy has been good at inventing credit products, such as home equity loans, consumer loans, and credit cards, but less innovative in providing long-term financial products for retirement security. The result is that we are stuck with either defined-benefit or defined-contribution approaches. There should be alternatives. Companies should establish retirement systems whose stability doesn't depend on making the right guesses about the stock market. Rather, all an individual should have to decide is the size of his or her desired retirement income and his or her minimum retirement income. No longer will the key to retirement be trying to figure out whether investing in distressed Argentinian real estate or biotech will beat the market. Fixed-income investments should cover the minimum-need income relatively risk-free, and a basket of riskier assets could be added to realize the desired level.



## THE NEW AMERICAN STORY

Individuals should be able to refer to their own Internet accounts to see how much they need to save each year, given different levels of returns, to produce each of those incomes. That way they can make the savings versus consumption trade-off more easily. If they are not saving enough, they may choose either to work longer or to reduce their desired retirement income. This exercise would remind people that there is no such thing as a free lunch. Before retirement, the savings would be converted into an inflation-protected annuity, which is a guaranteed real amount of money each year for life. To augment savings and pension dollars, people could also take advantage of the value of their houses with reverse mortgages or sell their life insurance policies as additional sources for annuity dollars. We need the best of the defined-benefit plans, which is annuitization, and the best of the defined-contribution plans, which is the portability of pensions from job to job.

Here are some specific policy changes:

1. Bring new state and local employees into the system, apply a part of the Social Security tax to all income, use the chained consumer price index as the basis for calculating the cost-of-living increase, raise the minimum eligibility age for Social Security, and narrowly liberalize disability eligibility for workers from sixty-seven to seventy who have had health-damaging jobs.
2. Provide the Pension Benefit Guaranty Corporation with an infusion of capital.

PROPOSING A SOLUTION

3. Require corporations to close shortfalls in their pension plans.
4. Stop lump-sum payments to pensioners of all the assets in their defined-contribution account if a company's pension fund assets fall below 70 percent of its obligations.
5. Replace the federal tax exclusion for contributions to 401(k) plans and IRAs with a direct federal matching program worth the same for all Americans, based on how much they save up to a certain level.
6. Establish a \$5,000 American Birthright account that compounds tax-free for every child born in America.
7. Develop new private pension approaches that are neither defined-benefit nor defined-contribution but that allow people to determine easily the amount they need to save annually to reach their desired retirement income. Invest most of the contributions in fixed-income assets that will be exchanged at retirement for inflation-proof annuities.

We can continue down the current path on pensions and someday find our golden years threatened, or we can face some hard truths and make effective changes now to secure our future. The choice is ours.