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as we see it Today

an editorial comment by **Hewitt Associates**

Public Policy for Private Pensions

Throughout the past five years there has been increasing discussion of public policy and private pension plans. The debate originated with the report of the Commission on Money and Credit in 1961, which recommended establishment of an appropriate regulatory body to set standards for investment of pension funds, to require periodic financial reporting to beneficiaries of the funds, and to bring suit against malfeasants on behalf of plan participants.

Early in 1962 President Kennedy appointed a special Cabinet-level committee "to review the implications of the growing retirement and welfare funds for the financial structure of the economy, as well as the role and character of private pension and retirement systems in the economic security system of the nation, and to consider how they may contribute more effectively to efficient manpower utilization and mobility."

Following nearly three years of work, the Committee produced its report in January 1965. The report spelled out its recommendations for public policy and private pension programs. It set the stage for a broad program of federal legislation and regulation in the interest of public policy.

Since the publication of the President's Pension Committee Report, a continuous flow of commentary is being recorded. Some favors the position of the Committee. Some voices active opposition. There does appear, however, to be growing agreement between the pros and cons that further study is required before legislation is seriously considered by Congress. To that end, the Joint Economic Subcommittee on Fiscal Policy held hearings during the month of May 1966. It is likely that additional hearings will be held by the Subcommittee and by committees of the House and Senate to which any legislative proposals may be referred.

Whether necessary or desirable, it appears inevitable that legislative control of pension systems will widen. Present and proposed legislation appears to be directed toward four general goals:

1. To protect against abuses or dishonesty. This is the kind of legislation typified by the Welfare and Pension Plans Disclosure Act and contemplated in the McClellan Bill and other legislation providing for restrictions on fund investments, requirements for trustee responsibility, and imposition of criminal penalties.

2. To assure fairness in the application of tax privileges granted to qualified pension and profit sharing funds and directly, or ultimately, to the participants for whom the funds are established and maintained. This is now achieved largely through legislation controlling qualified plans administered under Internal Revenue Service regulations, covering such areas as prevention of discrimination, and restrictions on amounts of tax deductible contributions.

3. To assure fulfillment of pension expectations. This would be the justification for legislation requiring a minimum rate of funding. It is the aim of proposals for reinsurance such as contemplated in the Hartke Bill for reinsurance of private pension plans. It is the motivation for suggested provisions for a federal depository and for assurance of benefits in the event of termination of a plan or a business.

4. To accomplish national social goals. In addition to other general goals there is throughout the Committee report the strong suggestion that pensions be controlled to meet broad social goals such as weighting benefits in favor of people who need the benefits most, and eliminating any positive influence pensions may have on job relationships to encourage mobility of the workforce. This would be the aim of legislation imposing requirements for vesting, portability, limitations on benefits for higher-compensated employees, and so forth.

This is a very broad classification of what appear to be the components of a developing public policy on private pensions. The following comments reflect our views on these goals from our vantage point of more than a quarter of a century of working with employers in designing and administering private pensions.

Protection Against Abuse or Dishonesty

We agree with necessary legislation protecting against abuses and dishonesty. Any weakness or inadequacy in present laws should be remedied. That existing disclosure of pension fund operations is an effective deterrent to abuse or dishonesty has yet to be validated. We do believe, however, that the public interest would be served by imposing stronger criminal penalties for deliberate wrongdoing.

Any legislative changes should put corrective emphasis on those areas most conducive to abuse, with a minimum of disturbance to the operation of the great majority of funds which are honestly and effectively managed.

We believe there is a need for: 1) a common definition of and agreement on the duties, responsibilities, qualifications, and functions of the fiduciary role in private pension systems; and 2) a delineation of investment practices that may involve conflict of interest or questionable propriety. Such standards of financial conduct may be more a matter of education than of government regulation.

Problems arise because of three types of circumstances:

1. Beneficiaries of corporate and union-management plans reside in more than one state, and frequently have no entity through which individual beneficiaries, each with relatively minor interest, can effectively join to determine and perhaps to protect their individual interests.

2. Effective policing of the activities of trustees (particularly individuals as opposed to corporate trustees) does not result from a system that depends on beneficiaries examining disclosure reports and bringing legal action where required.

3. Since the law of trusteeship is a responsibility of the states, in the absence of a uniform code of trusteeship there is no common legal view of the responsibilities of those who direct and administer employee trusts.

In an editorial comment dated May-June 1955 (three years before the enactment of the federal Disclosure Act) our editorial comment said in part:

> "The real solution for the future lies in further promoting employer and employee interest to prevent in all such funds any possibility of an environment in which corruption and abuses can exist.... Filing reports with a government agency would make the information available, but there can be a vast difference between having information available and creating interest and understanding in a specific situation. . . . A private communication program, . . . could lead to constructive efforts to improve the effectiveness of a plan.... Plan administrators should send an annual report to all employers, the union, and all covered employees.
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> "This report should include statements of the receipts and disbursements of the fund, total income and benefits paid, and complete data regarding all insurance premiums, claims, dividends, and retentions.... The Board of Trustees of union and management representatives should issue a yearly letter to all employers on the condition of the fund, policy decisions made, etc. . . . and each individual employer should tell his

> employees of the operation of the fund as it affects the particular group.
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> "Regardless of the particular techniques selected to communicate information on the operation of the fund, it seems reasonable to try to solve the problem not through government action but through creation of better understanding . . . . "

Even more strongly than in 1955, we believe that the greatest protection will come, not from disclosure to government, but from disclosure to the people whose interests are involved. Actual experience with disclosure legislation confirms this belief.

The need may not be for legislation which leads people to believe that the government can and will protect their interests, but rather for communication and education which will give people enough understanding and facts to enable them to know when their interests are in jeopardy.

Today we would include in the report to employees on the operations of the fund: the amount of benefits to which the employee is then entitled upon termination of employment, and the amount of benefit (based on his relative priority for receiving benefits) which the assets of the fund could provide if the plan or the company's business should be terminated and the investments liquidated or annuities purchased. This declaration must of necessity be limited by pointing out to the employee that these rights are not absolute or guaranteed and that the report is based on conditions on the day of the report and that his ultimate rights are subject to continuation of the plan until he becomes eligible for the different benefits.

Equitable Application of Tax Privileges

There is no argument against requirements for qualification for tax deferment for the purpose of legislating fair and equitable treatment.

Generally, we agree that the federal government should exercise some degree of control over the tax privileges granted through private pension plans. The bulk of pension law on the books today deals with this concern.

The weakness of the administration of the tax laws is in the attempts to achieve national social goals through the application of legislation intended to produce tax equity. Such interpretation and application of revenue laws should be eliminated.

One of the major weaknesses of our present system of tax incentives for retirement savings is that it is limited to funds provided by those employers who are willing and able to provide them. The need to devise means and methods for expanding participation in retirement systems is one of the major challenges for economic security today. Until such methods are found, the substantial portion of the labor force employed in very small business operations will continue to be discriminated against in the matter of tax equity. The enactment of provisions for self-employed persons and their employees has resulted in some incentive for retirement saving, but it does not appear to be an adequate answer.

In the past we have pointed out the fallacy of attempting to justify government control on the grounds that preferential tax treatment is a tax subsidy granted to private retirement plans by the federal government. In March of last year we submitted the following statement in testimony before a Subcommittee of the Special Committee on Aging of the United States Senate:

"A clarification of the real nature of tax incentives can help shed light on appropriate public policy for private plans . . . . Preliminary to a quantitative analysis is an understanding of who gets the tax advantage. There are two types of tax breaks involved in private plans. One is the deductibility of contributions made to a pension plan by an employer with no current tax liability to the covered employee. Whose tax advantage is this? It is not likely to be the employer's since it is most probable that if no retirement plan existed, compensation would be correspondingly higher. Certainly, contributions to private plans agreed upon in collective bargaining usually are substitutes for like amounts paid as wages which are an equally deductible expense to the employer . . . . Furthermore, in the case of employer-paid retirement plans of government or nonprofit organizations, there is no question of tax deductibility by the employer although individual participants are permitted tax deferment on employer contributions and accumulations. Clearly, public policy has established that the tax break is the employee's and constitutes the deferment of taxes by the employee until time of receipt of benefits.

"The other form of tax break is tax exemption of retirement fund earnings. Investment income is allowed to accumulate with no tax liability until benefits are actually received. In this respect, qualified retirement plans are treated in a manner similar to certain forms of individual life insurance contracts and U. S. Government Savings Bonds with deferment of tax liability on interest earnings. This tax advantage also belongs to the employee since he is allowed to postpone taxes.

"Judged from an economic standpoint, both forms of tax breaks in private retirement plans are advantages to the covered employee."

Later in the spring of 1965, we repeated this theme in a series of seminars sponsored by the National Foundation of Health, Welfare, and Pension Plans, with these additional thoughts:

"The Cabinet Committee Report contends that the tax breaks involved in private retirement plans give these programs a quasi-public character, and that the tax money which the government foregoes gives it the right to control what these plans provide. This control takes the form of limiting the choice of bargainers and administrators in such areas as the group covered, eligibility requirements to participate, type and amount of benefits provided, extent of vesting, degree of funding, etc. Better understanding of the nature of tax incentives involved can lead to a different interpretation than the Report has taken.

"There are basically two types of tax breaks involved. One is the deductibility of contributions made to a pension plan by the employer, with no current tax liability to the covered employee. Whose tax break is this? It is not likely to be the employer's, since it is most probable that if the union had not negotiated the pension contributions, an equivalent amount would have been added to wages, an equally deductible expense to the employer. This tax break is thus the employee's, and constitutes the deferment of taxes until time of receipt of benefits and is not a permanent foregoing of tax revenue. Since the employer is not receiving the tax break, arguments based on restricting the employer's choice have less validity.

"The other form of tax break is tax exemption for trust fund earnings. The pension trust, like many forms of tax-exempt organizations, is allowed to pay no tax on income presumably because of the social purposes being served."

Despite the fact that tax advantages accrue ultimately to individual employees, employers do receive something of financial value from the pension plans they establish and maintain. This value is derived largely from the tax exemption granted earnings on trust funds (but not from the tax exemption on employer contributions). This is the economic justification for funding retirement income through qualified plans. Because of the treatment accorded fund earnings under qualified plans, employers are able to provide higher retirement benefits than would be possible if earnings were taxed in the same manner as earnings of the business. To the extent that this serves a business purpose, the preferential tax treatment also benefits the employer. But the primary consequence of the business purpose, as well as the justification for the preferential tax treatment, is the well-being of the employee. The public interest is served through the ensuing greater financial support of people beyond their working years.

If we sincerely support the extension of private pensions, we cannot expect to encourage the payment, out of living income, of taxes on moneys set aside for the purpose of providing financial support in old age. Preferential tax treatment of retirement funds is fully consistent with a national policy of avoiding penalties through taxation which would prevent the use of private funds for worthwhile social purposes. It is not a tax subsidy.

Preferential tax treatment should be preserved. In fact, Congress should fully consider all devices which would extend the application of this concept to those not participating under present plans.

Assurance of Pension Expectations

Concern has arisen that participants in a pension plan may not receive the benefits prescribed by the program because of inadequate funding or plan termination. Two types of proposals have been suggested: to require funding of past service liabilities at a specified rate, and to insure against possible insufficiency of fund assets in the event of plan termination.

Under present requirements, a plan retains its qualified status only if it has funded for current service liabilities since the date of inception of the plan and has made whatever contributions are necessary to prevent the original unfunded liability from growing larger. The President's Committee proposes that unfunded liabilities should be funded over a period approximating the average work life of employees, but not more than thirty years. Even if this standard were universally adopted as a requisite for tax qualification, we question whether it would have a significant impact on guaranteeing pension expectations for two reasons:

1. Thirty-year amortization of unfunded liabilities is not a very good test of funding adequacy. A plan with a small initial unfunded liability which has not been amortized at all will likely have greater ability to provide promised benefits than a plan which has been making payments on a large unfunded liability for several years on the suggested thirty-year basis. Similarly, the extent of funding is subject to reappraisal whenever the plan is amended to increase benefits, creating supplemental unfunded liabilities. Use of different actuarial methods can result in identifying varying amounts as unfunded accrued liabilities. A better test of funding adequacy at any particular time is the comparison of total plan assets with total plan liabilities for service to date. The proposed requirement is unrelated to this type of test.

2. The true issue involved is whether pension expectations are more likely to be realized with a requirement for funding accrued liabilities over thirty years. There is little relationship between the two. If a plan terminates before all liabilities have been funded, there will not be enough assets to provide all employees with full accrued benefits. With the continuing trend for periodic benefit improvements, it is unlikely that many plans will be fully funded in the foreseeable future. Any funding requirements that suggest that full protection is guaranteed are liable to do more harm than good by creating false expectations.

We agree that security of benefits is desirable. We suggest a different approach which avoids the creation of problems associated with regulations dealing with unfunded liabilities, as such. First, after a reasonable period since establishment, a plan should be able to assure that it will provide benefits to persons retired, those eligible to retire, and those then vested.

Second, if a plan fails to achieve that funding objective, the trustees should be required to inform the plan participants of the fund's condition and its implications for the security of expected benefits.

Third, the penalty for inadequate funding should not be plan disqualification. Employee interests are certainly not served if plan termination must result if an employer's financial difficulties prevent funding standards from being maintained.

We further believe that forcing accelerated funding may result in an unwillingness on the part of employers to undertake programs which give credit for past service (or increase past service benefits), with the result that today's older workers may be severely penalized in terms of retirement income adequacy.

In lieu of higher standards for minimum funding, it might be more reasonable to liberalize present maximum funding rules as an incentive for employers to speed the accumulation process during periods when their business situation makes it most appropriate.

Assurance of benefits in the event of the termination of a plan or a business failure is another measure of security that government planners would like to see added to private pensions. Proposals involving a federal reinsurance scheme appear attractive on the surface, but in practice may require the imposition of so many requirements, restrictions, and mandatory standards on benefits, rate of funding and investments, as to diminish the attractiveness of private pension plans to employers. If so, depriving any significant number of persons of retirement coverage may be a high price to pay for the security of the few who might benefit from such legislation.

National Social Goals

Proposals have been made to impose requirements for vesting and portability. Obviously, increased vesting and transferability of pension credits achieve certain worthwhile objectives. The liberality of pension systems on these points is growing rapidly and will continue to grow without government control.

According to the proponents of legislation to force the achievement of these goals, required vesting would provide greater equity between those employees who stay with one employer and those who change jobs, and would promote greater mobility of the workforce. Also, they maintain that the impact of such requirements would be slight, since most pension plans already have vesting features. Let us examine these arguments.

1. "Vesting provides greater equity." At any given level of contributions to a pension program, vesting provisions result in some reduction in benefits for workers who remain covered by the plan until retirement age. Proposals for required vesting, therefore, rest on the assumption that pensions must, for reasons of equity, allocate more funds to those who leave and less to those who retire.

We believe there is some merit in the equity argument, but we do not agree that legislative action is required. Unfortunately, government-required vesting would have its greatest effect on new plans, since there is a definite correlation between the age of a plan and the presence of vesting features. This correlation exists for a very practical reason: the primary aim of a new plan is to provide an adequate benefit for those who retire, particularly those with long past service. As a pension program ages, assets grow and vesting tends to be added or liberalized.

Is it really so strange and undesirable that decisions on priorities arrived at by employers and unions stress adequacy first and equity second? Nor is vesting the only type of provision subject to this priority rule. Generally, there is also a correlation between the age of a plan and the presence of disability benefits, widows' protection, payments upon early retirement, supplemental benefits through savings and profit sharing arrangements, etc. Equity for persons who leave may not be of sufficient importance to alter this priority order. Is it reasonable to strive for equity at the cost of benefit adequacy?

In addition to the question of equity between employees or groups of employees, is there merit to considering that different employers have different things they hope to accomplish through the device of the pension system? It would not appear unreasonable also to take into consideration the rights of the employer to try to achieve his own legitimate business objectives, which contribute to the well-being of the employees as well.

It is in the area of vesting that a direct conflict develops between the basic objectives of many pension systems and the policy of forcing action in the "public interest."

If a pension credit is justified only as added compensation for work performed, it can be argued logically that it is earned currently and that its vesting should not be conditioned on future employment. Under this circumstance, it follows the credit probably should be determined on the basis of contribution or cost rather than benefit. Yet there can be objectives for a pension system other than added compensation for work performed. For example, an employer may want a system primarily to permit an orderly retirement of workers when they reach retirement age.

Employers usually hope that their pension plans will help to attract and retain workers until it is appropriate that they be retired because of age or disability. From the employer viewpoint vesting has the appearance of a severance benefit; and severance of desirable employees is an event that the pension may be intended to help prevent.

Vesting is frequently consistent with both employer and union objectives. But the amount of money that goes into a private pension plan, and the kinds of benefits it buys, should not be legislated.

2. <u>"Vesting overcomes impediments to labor mobility."</u> Mobility of labor is a desired national goal. To the extent that pensions represent one deterrent to the achievement of this goal, it is argued that required vesting will overcome this impediment.

Probably because of the complexities involved, there has been little research dealing with the effect of pension vesting on labor mobility. Studies that have been attempted have reached indefinite and contradictory conclusions. It is difficult to isolate any effect of non-vested pensions from many other factors which also could inhibit job changes, such as employer personnel practices, seniority, natural resistance to changing jobs, the working and social environment of the job, size and economic health of the employing unit, condition of the economy, etc. Contrary to much prevailing opinion, there is no conclusive evidence that limitations on vesting of pensions significantly restricts mobility.

3. "Requiring vesting will do some good and certainly no harm." It has been argued that since most plans, especially those that have been in effect for a decade or more, provide vesting to some degree, a reasonable legislated requirement will have no substantial adverse impact.

This line of reasoning is almost the same as saying that if such a requirement will do any good, it should be adopted because it is not likely to cause much harm. Required vesting cannot provide less equity; it cannot help but exert some influence for greater labor mobility. If it can't hurt and may help to some degree, we should give it a try, according to this argument.

Unfortunately, legislated vesting can hurt the private pension movement. Since its impact would be greatest on new plans, it would have the effect of retarding the establishment of pensions. And, among older plans, it would hit hardest the plans which, for financial reasons, have not yet voluntarily adopted vesting. In addition, the gradual trend toward more liberal vesting may be adversely affected by setting standards which in some cases will be less liberal than would result from independent action.

There are other possible adverse effects which could result. It is not enough to legislate a minimum vesting requirement; decisions also would be required in other areas. How much benefit is to be vested? How will this amount be determined in a plan with a limit on the number of years of credited service? In a plan which offsets part or all of the primary social security benefit? In a plan related to final average pay? How will the value of the credit be determined? What form is this vested right to take: deferred credit, cash, reserve forwarded to the next employer? These questions are likely to be answered by an additional set of cumbersome regulations, perhaps creating another impediment to the adoption of new plans or improvement of existing plans. If it is acknowledged that required vesting would be likely to do little good, it does not seem worth the price that would have to be paid for it.

We also believe that adoption of legislative requirements on vesting or portability of pension credits would set a precedent for other changes in qualification standards for pension plans.

Whatever we may believe about their effect on equity or mobility, the extension of vesting would result either in higher costs or in reduced pensions for workers reaching retirement age. A conclusion that the public interest is served by compelling the reallocation of available funds or the commitment of additional money is not warranted.

It appears that no practical system of portable pensions has been or probably can be devised, either through full vesting or transferability of pension credits, which does not involve standard specifications and uniform incidence of funding. To achieve these characteristics on a national scale would require a private system so rigidly controlled as to produce an unacceptable substitute for an expanded federal system. Certainly this is inconsistent with any public policy that values the preservation, growth, and expansion of the private pension system.

We believe that it is inappropriate to try to legislate social objectives through private pensions, and that the government's role is more properly one of preventing non-social behavior in private pension plans. Government should prevent such non-social behavior as defrauding employees, abusing tax deferment privileges, creating and taking advantage of false promises, and investing in securities of the employer for corporate purposes. There is a vast difference between preventing such non-social behavior and promoting social objectives.

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In viewing the total impact of the President's Pension Committee Report, we believe that the criticisms expressed by the Report are more symptomatic of a basic misinterpretation of the true nature of today's pension commitments than of any underlying inadequacy of the private pension movement itself.

The conclusions of the Committee suggest use of the same devices both "to further the growth of private plans" and "to improve their basic soundness and equitable character." There is no dissent on the desirability of basic soundness and equitable character. There is very little evidence, however, that these characteristics are not strong in the private pension movement at its present stage of development. Provision of greater income for retired workers, inherent in the private pension movement, is fully consistent with national social goals. Yet, the devices proposed to improve so-called soundness and equity appear also to be designed to try to force the attainment of national social goals. If forced attainment of social goals is accepted as a primary goal of private pensions, we may have to abandon spreading the private pension movement; but if we want the private pension movement to continue to grow, we shall probably have to encourage (rather than restrain) the flexibility for private design.

The question for national policy is: Are we going to further the private pension movement by preserving all reasonable choices for independent action, or are we going to try to reshape those plans that exist in an attempt to force instant fulfillment of national social goals at the expense of further growth and expansion of the private pension system? We probably cannot do both simultaneously.

Private pension plans are still in their infancy. Only about one in ten has been operating for 15 years or more and only about 25% are ten or more years old. Most of these plans are still in the process of accumulating funds to pay the liabilities assumed for employee service rendered before the plans were established -- and the additional liabilities accrued for benefit increases since the plans were initiated. In the face of substantial liabilities, employers are likely to be rather conservative in the pension commitments they feel they can prudently make in the early years of a program. We believe the reason for this conservatism as expressed in many of today's plans is not generally understood.

During the past 10 to 15 years, American workers have apparently come to expect more security from private pensions than they were designed to produce. This arises because of possible employee misunderstanding of the nature of the commitment which is made. The employer pledges to make contributions to a fund which, if the company stays in business and maintains the plan, will provide the stated level of benefits. But such an arrangement cannot guarantee pension security if the employer is not able to maintain the plan. The employer can no more make this promise than he can guarantee wages for an entire career.

Evidence of the disparity between employee expectations and employer commitments was reported by the Secretary of Labor this spring in his report to Congress on the operation of the Welfare and Pension Plans Disclosure Act. He said:

> "The Department has continued to receive many letters from participants requesting assistance in collecting benefits. . . . Many of these letters revealed a serious lack of knowledge about requirements to be met before benefits could be obtained."

It appears to us that the efforts of the President's Committee are directed primarily toward making false expectations come true. We suggest that it may be more realistic to shake the fairy-tale aura from pensions and to inform employees of what they can and cannot expect than it would be to attempt to legislate overly optimistic expectations into reality. To this end, we believe private employers should give serious consideration to communicating the nature of the commitment they have accepted in establishing pension plans. Difficult as it may be in certain cases, employees should be told clearly and honestly the extent to which benefits have been provided for and the extent to which accrued benefits could be paid if the company's business or the plan should be terminated.

If achieved through voluntary action and normal development, the results sought by the President's Committee may represent reasonable goals at some time in the future when the private pension system approaches something resembling maturity -- perhaps in the 1980's. But to force standards of maturity on a system in an attempt to cure occasional growing pains, seems to be prescribing stronger medicine than the ailment warrants and may threaten the entire system.

We believe it is in the public interest for government to encourage employers to clarify employees' expectations and to concentrate on creating an environment in which the system can proceed in an orderly growth pattern, with tomorrow's expectations based on solid reality.

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