LITERATURE REVIEW: PENSION REFORM

The idea of pension reform will undoubtedly create feelings of unease. Anyone who has worked for numerous years feels a sense of entitlement to a pension and to the idea that they will be taken care of throughout their retirement years. This is a natural sentiment based on the history of our country and the understanding that if someone puts in their time, they deserve to be rightly compensated. To reform any system that has been in place for years is not an easy task, but it becomes particularly poignant when it involves peoples hard work, monies and sense of security.

Governor Schwarzenegger of California felt it a necessity to have a pension reform throughout the state in order to alleviate the debt the state had accrued and he stated he was “about changing the entire political climate of our state and that he would not do things the way they’ve always been done” (Iammartino, 3). The Governor felt the “current pension system is ‘outdated’ and a liability to taxpayers” (Thomson, 1). Under his plan, “all new public employees hired after July 1, 2007, would only be permitted to participate in retirement accounts similar to 401(k) plans, rather than the guaranteed annual pension payments to which retired and current public employees are now entitled” (Iammartino, 1).

In general, “pension plans are established by corporations, unions, government agencies or other organizations to provide benefits (usually in the form of cash payments or non-cash assistance such as health insurance) to employees after their retirement from active service” (Iammartino, 3). Governor Schwarzenegger wanted to have all public employees switch to a defined contribution plan and in doing so, “the State of Californian would be responsible for a steady, predictable payment into members’ personal pension accounts each year, as opposed to a widely fluctuating amount. This increased degree of certainty makes defined contribution plans
a very appealing plan” (Iammartino, 8). However, “opponents of pension reform argue that
defined contribution plans are just as costly to administer as defined benefit plans, meaning that
pension reform will have little impact on the overall state budget” (Iammartino, 8).

A key point in the reform plan is that “the new formula discourages ‘pension spiking’ just
before retirement in order to boost annual pension payouts” (Archie, 1). In general, “most
employees obtain several promotions throughout their career, typically the peak annual salary
arrives near the end of an employee’s tenure, most likely the year just before retirement.
Unfortunately, this arrangement creates an incentive for employees to take promotions and then
rather abruptly retire. This leverages the higher salary of the new position into the pension
payout but leaves taxpayers to pick up the tab, a big one. Pension spiking is common in
California and costs taxpayers an estimated $100 million a year” (Archie, 1). “The costly peak-
salary rule that enabled fatter payouts is unique to the Golden State…Most states use a three-year
average of highest annual salary, but others like Minnesota and Indiana require a five-year
average” (Archie, 2). Since the current pension plan was instated the composition of the
workforce throughout the state changed dramatically, and “California witnessed an increase in
the number of retirements and a decrease in the average age of those who retire. In the rule’s
first year, retirements skyrocketed from less than 3,700 employees to more than 6,400. Since
that time, the state has averaged around 6,000 retirements a year with an average retirement age
of 59, two years under the median retirement age for the entire American workforce” (Archie, 2).
The idea behind the pension reform would help “the state maintain a more cost-effective
workforce by discouraging employees from taking positions temporarily in order to spike
pensions” (Archie, 2).
Quite obviously, there are people on both sides of this reform. Those in favor of this reform argue that “this money that’s going to go to pay for these skyrocketing pension costs and retiree pension costs is money that’s not going to education, higher education or our state’s infrastructure” (Wolowicz, 1). However, opponents of the governor’s proposal “feared the plan would bar widows of fallen firefighters and police officers from collecting their spouses’ death benefits. Also, Carolyn Widener, chair of the teachers’ retirement fund stated that “after two years of debate, we now know that the more dangerous retirement time bomb is in the private sector. Meanwhile, the insistence on attacking our successful state pensions is similar to a doctor prescribing surgery, but then amputating the wrong leg” (Wolowicz, 2). Both sides of the argument have valid points but as long as there are strong and equal advocates for all parties involved some type of fair compromise should ensue.

Works Cited


Pension reform has become a rather hot topic in the United States within recent years due to the impending retirement of the Baby Boomer Generation. With budgets getting tighter not only has the federal government given thought to this impending possible financial crisis situation, but also individual states are beginning to examine their public pension system for state employees. Much of the research performed in the area of pension reform lies outside of the United States. Canadian history and theoretical considerations demonstrate that adequate pensions are not possible without government pension plans. Canada has gone through multiple evaluations of its pension reform plans and resulting assessments are that the public plans have not expanded. Employer pension plans have not been improved adequately with regard to coverage, vesting and indexing. Thus, the reformed system does not and will not provide sufficient replacement income to allow middle-income Canadians to maintain their standard of living in retirement (Ascah 1996). In Ontario there are three basic plan designs that have been examined and it has been recommended that growth of defined contribution (money purchase) plans should be encouraged as an important means of reforming the private pension system (Balcer 1982). Under the combined impact of all the reforms in Canada there is an estimated increase in total pension costs. Most of the increases are due to pre-retirement indexation. The results also show that it would be practically impossible to subsidize the additional benefits of older workers through their own contributions, or contributions made on their behalf (Balcer 1984).

Chile has also gone through some major pension reforms during the 1970’s – ‘80s. In the mid-1970’s Chile initiated a deep market-oriented reform program aimed at opening up the
economy, privatizing state-owned enterprises and stabilizing the macroeconomy. One of the most admired aspects of the Chilean program has been the reform of the pension system, which replaced an inefficient pay-as-you-go system with a privately administered defined contribution system. This reform has been credited with helping develop Chile’s capital market, with reducing government contingent liabilities and with helping boost Chile’s low savings rate (Edwards 1996). However, in the case of Chile it has been found that there are personal pension gaps, which are closely associated with informal sector and low paid jobs, they’re also associated with younger workers, married women and the self-employed. These gaps in coverage will lead to poverty and hardship for the elderly population and inflated future government welfare expenditure. Countries wishing to follow the Chilean model of pension reform will need to take these issues into account and incorporate design features to maximize pension coverage (Barrientos 1996).

The experiences of Denmark and the Netherlands suggest that different pension regimes are capable of producing “social democratic” outcomes such as poverty alleviation, reducing income inequality, and covering various risk profiles. In Denmark, Sweden and the Netherlands initial choices concerning the structure of basic and occupational pensions significantly shaped subsequent pension development. However, there are long-term implications of government funded pension programs – citizens would adapt to the public system and private savings would decrease, and as each year passes it would be more difficult to switch to a privately organized system (Anderson 2004). Research panel data indicates that defined benefit plans are being replaced with 401(k) or other defined contribution plans. 401(k) plans are not avenues for net savings but are total replacements for the more traditional pension forms (Papke 1999). Although replacing defined benefit plans with defined contribution plans is a cost saving solution
for companies, pension plans are a more efficient method of attracting and retaining quality workers than inflating wages (Clark 2000).

Recently, there has been much discussion over reforming the Social Security benefit in the United States. The U.S. government is interested in transforming its partially funded public pension plan into individual retirement savings plans managed by private providers. Currently the U.S. has a pay-as-you-go pension program, which is coming under stress due to its substantial aging population, leading to rising tax rates and/or benefit reductions (Salisbury 1992). Estimates of the impact of ageing population suggests that the payroll tax rate needed to finance social security expenditures in the United States over the next fifty years could rise to between 18 and 23%. Estimated gains from replacing the public pension program with individual retirement savings accounts could be as high as 2.4% of the GDP (Feldstein 2000).

References


Pension Reform in America: Requirement or Rhetoric?

Given the salient nature of pensions (i.e., tens of millions nationwide depend on pensions to fund their retirement), as well as the heated debate on pension reform, academics have had (oddly) little to say about the subject. This may largely be the result of the few choices available to reformers (government-run or privately held) as well as the fact that neither of these two possibilities are extraordinarily esoteric. The problem with pension reform, then, is not the possible solutions: it is the unknown aspect. What is going to happen in the future? How will intergenerational equity affect the retirees of the future? How will market actions impact future retirement benefits? Increased knowledge of these questions is the only way to properly inform the pension reform debate – and this is easier said than done, as the Danish physicist Niels Bohr once attested to: "prediction is very difficult, especially about the future."

Once delineated into this framework, the review on the literature becomes focused on the costs and benefits of the two basic options. Moreover, the debate may be largely theoretical: the move from employer-based defined benefit plans, in which benefits are paid via a formula based
on salary and years of service (and perhaps most importantly, one in which the investment risk is on the employer) to defined contribution plans in which the employee is largely responsible for their own retirement, funded by self-made contributions and market returns, are showing path dependent effects. Specifically, employers who once utilized the defined benefit program are now replacing those programs with 401(k) programs, as well as other similar defined-contribution plans, and that offering a defined contribution plan will increase the probability that the defined benefit plan will be terminated. (Papke 1999). The problem with this, Papke argues, is that it decreases net savings, due to the inherent flexibility of defined contribution plans.

Furthering these findings, Poterba, Venti, and Wise (2000) consider the efficacy of individual level investment decisions on future asset accumulation, as well as the impact of external factors on self-directed retirement funds (e.g., management fees, contribution rates, and early retirement), and find that external factors are more of a determinant of successful retirement savings than are individual level decisions, based on past results. More recently, Samwick and Skinner (2004) find that the evolution of defined contribution plans thorough 1995 resulted in “roughly similar median benefits and higher mean benefits” when compared to defined benefit plans. Some features of the defined benefit plans are still useful however; automatic enrollment in defined contribution plans leads to contribution rates and allocations being maintained longer than do non-automatic enrollment plans (Madrian 2001).

Considering the possibility that defined contributions and defined benefit plans are not mutually exclusive, Nataraj and Shoven (2003) examine PAYGO type accounts (such as Social Security) and individual accounts, and finds that individual accounts will lead to higher rates of return, but that a two-tiered program (featuring both defined-benefit contributions and individual account segments) would decrease the level the volatility of individual level accounts and the
raise the return of the defined benefit sector). Similarly, Feldstein and Rangelova find that a “pure defined-contribution plan with a 6 percent savings rate invested 60-40 equity-debt personal retirement account can cut an individual’s cost of providing a retirement annuity to one-third of the projected 18% PAYGO tax while leaving the retiree exposed to relatively little risk” (2001).

A third contribution to this vein of literature considers a Floridian plan to allow displaced members who have been forced to transfer to defined contribution plans to “buy back” their defined benefit for a price in an attempt to help protect defined contribution members from risk (Lachance, Mitchell, and Smetters, 2003). The authors find that if the buyers exercised this plan wisely, the market value of the option could represent up to 100% of the defined contributions over their work life.

Another question arises when one considers the effects of individual level action on market forces, which would (assuming the effects were net negative) in turn question the efficacy of defined contribution plans. In particular, Benartzi and Thaler (2001) argue that many investors in defined contribution plans follow a “1/n” strategy: dividing their contributions evenly across the funds offered in the plan, resulting in a proportion invested in stocks that is equal to the proportion of stock funds in the plan. Conversely, aggregate level decisions may have an effect on pensions themselves. In particular, Coronado and Sharpe (2003) argue that the extraordinary returns on defined benefit plans artificially inflated corporate income statements, which indirectly led to a stock market “bubble” burst.

In conclusion, pension reform policy is not unlike many other policies, in that those who need the most assistance via expert intervention – government or otherwise – are the least likely to get it. In other words, those who have had the ability to become educated about the market will likely benefit from defined contribution plans; those who have not will likely suffer from the
many pitfalls inherent in self-directed investment accounts. Defined contribution plans may simply be a rationalization by the upper classes that they will “stay out” of people’s financial life, when in reality, is most likely a vehicle to reduce costs and increase market capitalization thereby keeping interest rates and inflation lower.

**WORKS CITED**


PENSION REFORM

The quest to balance state and federal budgets propel policy makers to consider new models to reform state pension and Social Security plans. Government managed retirement accounts are putting a growing burden on taxpayers as life expectancy increases and birth rates decrease. There are not enough adults in the workforce to fund the current and future retirees (Ferrara 1987, Mason, Mills, and Ferrell 2005, Archie and Ferrara 2006, Whiteford and Whitehouse 2006). Reform of the plans requires an incremental process toward the utilization of private industries to replace government as providers of retirement and disability benefit funds.

The Social Security Administration (SSA) imposed the first step of reform by tying reduction of SSA retirement benefits of state and federal employees with the amount they received from their state pension fund after 1985 (Mason et. al. 2005). The Windfall Elimination Provision of 1983 affected retirees that had not paid into SSA for thirty years and significantly impacted persons that had not contributed for twenty years (p. 53). SSA accounts for half of all U.S. federal domestic spending (Ferrara 1987) and one-third of all federal outlays. The “Pay as you go” calculation (p. 50) had adequately funded plans in the past but the increased life expectancy rates resulting in at least twenty years in retirement (LaComba and Lagos, 2006, Whiteford et al. 2006) and decreased birth rates compared to the baby boomer generation are bankrupting the system. By 2035, SSA will be paying out twice the amount it collects per year. Ferrara (1987) proposes further reform by allowing young workers to invest a portion of their SSA tax privately for their retirement. This plan could only work for the young employees because eliminating SSA abruptly would financially cripple retirees for the next twenty years.

The models of state pension plans that need to be reformed are in a similar condition as SSA for funding and have the additional shortcoming of only counting income earned in the final
years of employment instead of using a lifetime average wage rate. This calculation method allows employees close to retirement to capture overtime and special project pay to boost the retirement rate they’ll receive (LaComba et al. 2006). The final area of contention relates to modern thought- that employees have the right to choose where their money is invested. State pension plans (defined benefit plan) do not offer this choice (Archie et al. 2006).

The privatization of retirement funds and selection of the investment fund distribution is the most common proposal for state and federal pension reform (Miller 1995, Archie et al. 2006, Chao 2006, Whalen 2006). U.S. Department of Labor secretary Elaine Chao said in 2006, there were forty-four million workers who depend on defined benefit pension plans and they should be allowed to save in a defined contribution plan (p. 674). In 1994, it was reported there were thirty-two million persons in a single employer pension plan (Miller 1994). These millions of public and private sector workers may be investing in a fund that is under-funded leaving it to the current wage earners to make up the difference (Ferrara 1987, Blount 1994, Archie et al 2006, Whalen 2006). In 1994, freshman house member Enid Greene Waldholtz proposed sweeping changes to the congressional pension fund (Miller 1995). To set the example for states, she wanted to reduce the amount of pension benefits for congressional members and she wanted congress to switch to investment in a 401K plan for members’ retirement funds.

In addition to reducing the tax burden, another benefit of switching pension investment from the government role as fiduciary to a facilitator of savings by workers allows for portability of the fund (Whalen 2006). Workers would not have to remain in a state position for thirty years in order to access their pension fund (Miller 1994) thereby preventing old age poverty (Whiteford et al.2006) while removing the burden on state and federal programs (Ferrara 1987, Archie et al. 2006).
Replacement of outdated plans with portable, worker selected investment strategies not only provides an increased number of workers access to retirement accounts, research reveals 61% of employees would have increased returns as compared to the defined benefit state pension fund (Archie et al. 2006). By 2005, twenty states had already switched to a defined contribution plan and 92% of American companies offer a 401K plan for their workers (p. 43). Back in 1987, Peter Ferrara proposed this change for SSA to private sector for not only retirement accounts, but also death benefits, disability insurance, and health insurance (p. 56–57). He contends that the private sector can better manage the funds due to market competition and budget constraints to stay in business. I disagree with removing death benefits from families of workers. Lump sums from life insurance policies of a young parent will thrust the survivors into poverty. This safety net must remain in the long term care of the government to prevent childhood poverty.

In order to realize pension reform at the state level, ballot initiatives have proven to be effective (LaComba et al 2006). Education of the voter regarding the benefit to the majority was accomplished by making the median wage earner the median voter in the example. Legislators can enact the policy changes but will experience backlash from the fear of poverty or injustice without comprehensive education about the benefit to the state worker and the tax payer.

Reform of outdated and under-funded government pension plans is necessary to balance budgets, reduce poverty rates of older Americans, and provide a choice to the current workforce. In today’s market, allowing the employer to manage the employee’s defined contribution, portable fund in conjunction with a private financial investment firm provides an equitable solution to replace an antique model.
References


Once upon a time, American companies developed a pact with its workers. Give us your hard work and sweat and we will take care of you when you retire. However, many Americans have seen that promise broken as companies now frequently renge on what was once a staple of retirement life, the defined benefit pension plan.

In 1974, the Federal government created an insurance system for businesses offering private pensions, the Pension Benefit Guaranty Corporation (PBGC), and the insurance is funded by premiums collected from employers. The PBGC protects the pensions of 44.4 million workers and retirees in 31,200 private defined benefit pension plans. When businesses fail to fund their pension plans and are unable to meet obligations to their employees, it puts a strain on the entire pension system. If there is not enough money in the system to cover all the extra costs, American taxpayers could be called on to make up the shortfall.

In the 1980s and 1990s, the United States experienced an incredible level of sustained economic growth that lasted nearly twenty years. Life was good, yet this growth affected the pension system in a number of ways creating a “perfect storm” of economic conditions that would lead to the crisis the system is now experiencing. Due to the strong economy, many pension plans had high asset values and were therefore well-funded. The economic prosperity led to the Treasury Department in 2001 to discontinue the issuance of the 30-year Treasury bond after a 3-year buy back program. The 30-year Treasury bond interest rate is used as the interest rate assumption to
value plan liabilities and lump sum benefits. The initial impact was not felt due to the high asset values during the buy back period. In addition, the interest rate assumption was weighted over four years so that in effect, the discontinuance of the bond was phased out in its application for pension plans. Since many in the business community believed the 30-year Treasury bond interest rate was not in their favor since most plans were invested in corporate equities, they lobbied successfully for a change to the interest rate assumption. The discontinuance of the 30-year Treasury bond strengthened this argument (Wong, 2006).

Exacerbating matters, in 2002, the PBGC took over the largest plan failure in history, Bethlehem Steel, both in terms of the number of participants and the amount of underfunding. According to PBGC estimates the plan was 45 percent funded, with $3.5 billion in assets to cover $7.8 billion in benefit liabilities (Clerihue, 2002). The plan failure was soon followed by other failures of similar scale so that by 2004, the PBGC budget surplus had turned into a $23 billion budget deficit. In 2005, United Airlines replaced Bethlehem as the largest pension plan failure in history and lumped about $6.6 billion in pension liabilities upon PBGC. Retired pilot Ray Brice saw his $12,000 per month pension sliced to a relatively paltry $2,000 per month (Kirchhoff, 2005). Bankruptcies and retirement plan meltdowns in the steel, retail, airline, and other industries increased the financial pressure upon PBCG to unforeseen levels.

Just when it could not get worse, it actually did. The once robust American economy slowed to a crawl. Corporations were now facing a combination of falling interest rates, decreased asset values, a slow economy, and increased plan liabilities. They were encumbered with significantly increased pension contributions at a time when they were at their weakest point financially. The
combination of the stock market swoon and historically low interest rates, which make long-term obligations appear larger, resulted in a rapid decline in pension funding. Pension benefits that may have seemed affordable when first granted now became an anchor that threatened the survival of the corporations themselves.

The cumulative effect resulted in millions of workers’ pensions being dramatically reduced or eliminated as corporations attempted to navigate the unpredictability and volatility of funding these plans. Some companies have seen contributions double or triple in recent years; a $100 million contribution one year suddenly becomes $300 million the following year. Such volatility negatively impacts a corporation’s financial statement, which raises the ire of financial analysts who grade the company (Sammer 2005).

Such mismanagement of pension accounts has naturally hit retirees hard. Fred Freshwater of Coraopolis, PA worked as a pilot for US Airways for 29 years saw his company declare bankruptcy in part to alleviate the financial burden of its pension plan. His pension was reduced from over $100,000 a year to about $35,000. Yet, in an appalling and disgustingly typical move of corporate America, the former US Airways CEO, who actually led the company into bankruptcy, walked away with nearly $6.1 million in severance pay when he quit in 2004 (Wereshagin 2006).

In June of 2004, PBGC reported that companies with underfunded pension plans reported a total pension shortfall of $278.6 billion, up from $18.4 billion in 1999. However, only companies with more than $50 million in underfunded pension liabilities were included in this figure. The
report further states that “if underfunding in all insured pension plans is included . . . the total shortfall in the defined benefit pension system is significantly higher than $278.6 billion” (PBGC 2004). Concern spread throughout the government that if PBGC’s deficit continued to grow, the agency could go bankrupt which would lead to a politically devastating taxpayer bail-out.

Prompted by the default in recent years of so many large defined benefit pension plans and the increasing deficit of the PBGC, the Bush Administration advanced a proposal for pension funding reform, which was designed to increase the minimum funding requirements for pension plans and strengthen the pension insurance system. After six months of Congressional debate, President Bush signed The Pension Protection Act of 2006 which promised sweeping reform of the pension system. The legislation requires the following:

• Requires companies that under-fund their pension plans to pay additional premiums;
• Extends a requirement that companies that terminate their pensions provide extra funding for the pension insurance system;
• Requires that companies measure the obligations of their pension plans more accurately;
• Closes loopholes that allow under-funded plans to skip pension payments;
• Raises caps on the amount that employers can put into their pension plans, so they can add more money during good times and build a cushion that can keep their pensions solvent in lean times; and
• Prevents companies with under-funded pension plans from digging the hole deeper by promising extra benefits to their workers without paying for those promises up front. (Snow 2006).

No one argues that something needed to be done, yet not everyone is satisfied with the new law. Robert Reich, former secretary of labor in the Clinton Administration and professor of public policy at the University of California, Berkeley points out during a public radio commentary that even though the law requires companies to fully fund their defined benefit pension plan, it eliminates any incentive for companies to set up or maintain such plans in the first place. He predicts a “stampede of companies to follow the lead of Hewlett-Packard, Verizon, Motorola and
IBM in terminating their defined pension plan altogether. If a company has contracted with its union workers to offer such a plan, expect them to follow the lead of several major airlines and threaten to, or in fact, go into bankruptcy to get out from under the contract” (Reich 2006).

Karen Ferguson, director of the Pension Rights Center, a consumer advocacy group in Washington had stronger criticism. In a statement released minutes after the President signed the bill, she wrote, “The so-called ‘Pension Protection Act of 2006’ is a great disappointment. It wipes out key protections for workers and moves retirement policy in the wrong direction. The Act increases the likelihood that companies will jettison secure pension plans in favor of insecure do-it-yourself savings arrangements. This does not bode well for future retirement security. She ended her statement by saying “the best that can be said for the Pension Protection Act of 2006 is that it could have been even worse” (Ferguson 2006). Not exactly a ringing endorsement.

Several experts share their concern. Since the new reform relies upon self-managed, individual plans such as 401(k)s the law encourages employers to make enrollment automatic. However, the plans are rife with shortcomings. Many employers do not offer such plans, workers can still opt out and those that do participate often do not save enough or withdraw money before retirement. And finally, many employers do not match employee contributions (Trumbull 2006).

According to a recent study by Hewitt Associates, a global human resources services company, many corporations are reexamining their retirement plans in an attempt to balance financial responsibility to shareholders and analysts and their commitment to employees and retirees. The legislative and financial environments in conjunction with rising costs have made this juggling act even more complicated (Hewitt 2007).
It is quite apparent that the defined benefit pension plan will become as common as the black and white television or the 8-track tape. Defined contribution plans are now the standard as more defined benefit plans are phased out. Thankfully, most young people in the workforce have learned the lessons of retirement self-reliance and will not rely upon the existence of a defined benefit plan, or even Social Security for that matter. They realize that their retirement will have to be financed by their own savings (primarily through portable 401(k)s or 403(b)s), earnings and investments. They would be wise to consider any other source of retirement income from the government as a bonus. Specifically, this current pension crisis threatens to impact countless millions who are now rapidly approaching retirement age. The Pension Protection Act is indeed a good start, but this problem is far from being fixed. Governmental debate must continue regarding the best course of action to alleviate this situation, keeping in mind that time is of the essence as so many baby boomers approach retirement. It would be a shameful tragedy for so many promises to be broken.

References


Retirement, as a concept, is by no means ancient. The logical enabler of this idea, pensions, is even newer. As a means of renewing the workforce and rewarding laborers for years of service, they are themselves undergoing changes in both philosophy and practice. The relatively short-lived period of a guaranteed salary after retirement graduate to uncertainty as pensions look to the market to maintain otherwise unsustainable benefit packages.

In the armed and civil services, pensions began as a way of encouraging disabled or long-serving members to make way for younger, more active recruits. This trend carried over to the private sector in the 19th century as rewards for career employees. Later justifications emerged to perpetuate the institution. The concepts of human depreciation, deferred wages and the increasing need for retirement, disability and survivor benefits are examples of this. The idea of wage replacement only appeared recently. (March, 1980)
Today, pensions fulfill a number of functions in the labor market. They serve as an incentive for employer-employee loyalty, as a tax shelter for deferred income, as liabilities or assets, depending on the needs of the corporate accountant, and finally as retirement insurance. (Bodie, 1990) There are two general categories of pension plans, defined-benefit and defined-contribution. The defined-benefit plan uses a formula to calculate the amount the participant will receive. The variables include, most often, time in service, and wages, generally at or near their highest point. Some add Social Security benefits into the formula. In a defined-contribution plan, the participant invests in an account (often including a percentage matched by the employer). The amount invested and the interest is has accrued belong to the participant at the time of retirement. (Bodie, 1990)

One additional difference between the two categories is in the regulations applied. Defined-benefit must abide by strict rules as regard funding status, actuarial assumptions, and actuarial methods. They have minimum funding requirements, maximum funding limitations, minimum vesting rules, and must be insured through the federal government. (Gale, 1994)

Historically, defined-benefit plans have dominated the landscape for a variety of reasons. By 1993, more than half of covered employees participated in defined-contribution plans. (Samwick and Skinner, 2004) This conversion has exposed workers to greater risks than previously encountered. (Pennacchi, 1999)

This is not to say that defined-benefit program were without risk. Particularly in the case of state and local government pensions, they are often underfunded, lack consistent and clear reporting requirements, allow for early retirement which increases benefit payout, and are not integrated with Social Security. Structurally, they face rapid growth and uncontrollable
budgetary impacts. Finally, on a socioeconomic level, they are forced to deal with a declining birth rate and what is known as the “graying” of America. (March, 1980)

Defined-contribution plans deal with a different set of obstacles. Currently, the system is constructed to deal with a short list of risks. These are the longevity risk, or the possibility of living longer than one’s assets, the replacement risk, benefits will not maintain current standard of living, social security risk, possible cuts in benefits, and investment risk, poor investment performance. (Gustman, Mitchell, and Steinmeier, 1994)

Considering the risks inherent in each system, I am inclined to believe the defined-contribution plan is the only feasible path for the future. As population growth slows, life expectancy rises, and medical care improves, we can not continue to live on the backs of labor. How can I expect my son to pay for my retirement in the knowledge that he will have no such comfort and, in fact, will have to work much longer to enjoy the fruits of his labors?

Bibliography


Pension Reform

At the top of most political debates you will find healthcare and taxes, but following in a close third lays pension reform. Every national political campaign at some point must confront the hot button issue of social security and its fluidity. Policy makers now must face corporate pension buyouts, pension fund failures, and a retiring baby boomer generation that will deplete the entire social security system. Millions of workers will be retiring within the next five years taxing the system to the brink of collapse. With such serious and far reaching effects the impending collapse of pensions, both private and public, policy makers must give this issue an immediate urgency.

The exact causes of pension failure are multifaceted. On the private side there are many poor investment decisions that lost millions of dollars in retirement funds, the weak stock market made the situation worse. On the public side, such as PERS, we again see poor investment decisions and management problems. Many politicians found that increasing PERS contributions by the employee, which was needed to keep the system afloat, affected them
negatively at the polls. The employees didn’t want to contribute more; the employers didn’t want to increase their share of contributions, the effects of inflation, and the increase in the amount of those retiring brought the system to the brink of collapse. Many employees feel that the pension is part of the employee-employer relationship and that it is the responsibility of the employer to keep the pension fund afloat to create a positive workplace environment (Gustman, 1994). The system wide instability forced elected officials and governing boards to take drastic measures to fix failing pension plans nation wide.

Some solutions were very unpopular such as raising retirement ages and decreasing benefits to those already retired. Another solution was a large increase in payroll deductions to cover the diminishing money reserves. Each solution brought with it many critics and negative effects. In January 2005 newly elected California Governor Schwarznegger began to take drastic steps to save the state’s failing system. One such measure he proposed was to create retirement accounts, such as a 401(k) plan, that would replace guaranteed pension plans for state employees. This brought much protest from the states’ two largest labor unions the California Teacher’s Association and the California Department of Corrections Union. In a study measuring the changes in public pensions, Bruce Kennedy measured several incremental changes to the public pension system in Canada and found that many anti-poverty groups and labor organizations didn’t even notice when money was being directed to or from their constituents, this benefitted both the plan and the businesses (1990).

The main objective of reform is to restore the compatibility of social policies with the changing economic and demographic contexts (Bonoli 2000). Giuliano Bonoli compares the pension reform practices across Europe and uses the United States as his early examples. He believes the pension reform debate started in U.S. in the mid 1980s. Bonoli finds that pensions
are the single largest social expenditure, so as a result are also the first place cost cutting
measures are enacted by politicians. This leaves many plans unstable. In a study by Augusto
Iglesias he finds that capital markets encourage private pension plans thereby remove funds from
politician’s hands (1996). Barry Bogsworth and Gary Burtless studied whether an increase in
the public or private pension systems would encourage an increase in national savings, thereby
reducing the burden on future workers (2004). They determined that not only did it not increase
savings, but in a national pension system, cause money to be redirected from other budgetary
items into the pension plan to cover losses.

The U.S. has taken large amounts of money from the Social Security System in efforts to pay
of others debts or pay for pork barrel spending projects turning what was a self funded system
into a pay as you go system. In a World Band Report Robert Holzmann discusses how a pay as
you go system is virtually ineffective due the change in fertility rates and fewer workers entering
the public Social Security System, this unfunded plan is too risky and will cost tax payers undue
stress (2005). Social security systems both in the U.S. and world wide face the added problem
associated with low wages. Low wage earners and the poor rarely set money aside for retirement
creating a dependency on a system that will provide very little funds when retirement comes.
Dimitri Vittas in a report for the Brookings Institute describes the situation as devastating
especially when coupled with inflation (1995).

Lawrence Thompson conducted a study of the few times that there was major overhaul of the
Social Security System. He believes that there is no real political consensus for real reform. He
finds that politicians are unable to determine what is actually wrong and what would prove to be
a superior alternative (1983). Montgomery, Shaw, and Benedict conducted a study to determine
the relationship between a growth in pension benefits and a reduction in workers wages and
other compensation (1992). They determined that there was indeed a loss in competing wages in many efforts to correct the failing pension plans.

One other aspect of pension reform is, whether or not a public sector employee will get over compensated relative to their private sector counterpart when it comes time for retirement? Lee Craig looked at the Federal Pension Plan to answer that very question (1995). Craig argues that the federal plan takes on a rent seeking context which is not found in private plans due to their ability to use tax shelters; this is not available to the federal plan because the government does not tax itself. One other benefit the federal plan has is that those who benefit from the plan are the same people making the rules and contribution rates.

Pension Reform

The case study of the pension reform in California starts out by summarizing the events leading to this reform. The California people were unhappy with the governor, Gray Davis, and voted for a recall. The budget and spending was out of control and the state needed some direction. In the special election, the people of California voted the actor, Arnold Schwarzenegger, into office.

In order to keep skyrocketing deficits under control, pension reform for the state employees was suggested. Pension plans are established by businesses or government agencies and is “designed to prepare the employee for the reduction or loss of income” after retirement. (Nader, 1986, p. 1055). The benefits are usually in the form of cash payments. In California, there are two public employee pension plans. First is the Public Employees’ Retirement Fund (CalPERS) and the second is the State Teacher’s Retirement Plan (CalSTRS). (CR16-06-1837.0)

With the new governor in office, a plan to help with the escalating deficit was developed. A shift from the existing defined benefits plan for government employees to a defined contributions plan was suggested. In a defined benefits plan, the employer has the responsibility to fund all of the pension plans. They are required to pay a certain amount to a retired employee based on their earnings. In a defined contributions plan, it is up to the employees to manage their own retirement fund. The burden primarily falls on the employee in this plan.

A defined contributions plan has certain rewards but also has certain faults. Within a defined benefits plan, the employer must funnel in the same amount of money no matter what the market or stocks have done. In a defined contributions plan, all of these risks can harm an employee’s retirement; they foot all the risks. Along with potential market crashes, a risk in these defined contributions plan is that there is a chance for the employee to outlive the assets
they have saved. Since it is up to the employee to allocate money for their retirement, they may fall short of what will be needed.

According to the literature, there are benefits to both pension systems. The United States is one a few countries that do not have a national pension plan, outside of Social Security. In researching this topic, the vast majority of literature on pension reform addresses problems in other countries. It was very difficult to find any literature regarding pension plans within the United States. For example, the article by Junko is a comparative study of public pension plans in the United States and Japan. It was focusing on the financial crisis during the 1980s in both countries. (Junko, 1991)

Another article, by Williamson, compares the defined benefits plan and the defined contributions plan in several European countries such as Italy, Poland, Sweden, Mongolia, Latvia, and Kyrgyzstan. He proposed a “four pillar model” to address the issue. (Williamson, 2004). Not only were many of the articles relating to plans in Europe, a portion focused on Canada. The article by March that also looked at different forms of pension plans, took place in Ontario.

An interesting article that illustrates a dark action taken by firms regarding the pension plans of their employees came to light. There are some firms that have created a “penalty for early quitting” but have also taken to “opportunistic firm behavior.” (Cornwell, Dorsey, & Mehzrad, 1991, p. 704). Since pensions are “generally a function of highest earnings, when nominal earnings are expected to rise, an employer can reduce pension liabilities by discharging workers prior to retirement.” (Cornwell, Dorsey, & Mehzrad, 1991, p. 704). In other words, a company can get out of paying out hefty benefits by firing employees early. The paper is a study trying to determine if this sort of behavior is systematic. The article by Carrol and Niehaus
examined the relationship between defined benefits plan and corporate debt ratings. They found that “unfunded pension liabilities reduce debt ratings more than an equivalent amount of excess pension assets increase debt ratings.” (Carrol & Niehaus, 1998, 427).

Pension reform seems to be an important topic, outside of the United States. Again, the majority of the literature focused on this reform in many different countries. Throughout the literature, however, two main plans were still dominant: defined-benefits plan and defined-contributions plan. There are definite benefits to both, as well as risks. Throughout the literature however, it seems that defined-benefits plan creates more of a risk to the employer. This is because they have a fixed amount they are required to contribute no matter what is happening in the market. A defined-contributions plan is more dangerous to the employee because they bear all the risk. Not only is it up to the employee to allocate enough funds in order to reap the benefits later in life; but they also have to watch out for market failures. Both plans are reputable but both have their flaws.

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CR16-06-1837 Kennedy School of Government Case Program: Pension Reform in California.


Pension Reform

During the past six years in American Politics, pension reform has been a hot topic which has seen much debate. Recently, the state of California, which is in many respects equals the complexity and size of small countries, has attempted to tackle this very issue. Governor Schwarzenegger has proposed the conversion of the state’s public employee pension plans from defined benefit plans to defined contribution plans. Under this proposed plan, all new public
employees hired after July 1, 2007 would only be allowed to participate in retirement accounts similar to 401(k) plans, rather than the guaranteed annual pension payments to which retired and current public employees are now entitled.

The current system, a defined benefit plan, gives retired members a guaranteed stable periodic benefit payment until the member dies or chooses to leave the plan. Members must pay a certain amount into the plan from their payroll during each year of active service and employers must also contribute a certain amount into the plan. These pooled funds are managed by professional plan sponsors to ensure that the plan has sufficient assets to pay current and future benefits.

The proposed defined contribution plan, on the other hand, entitles retired members to receive variable benefits that are determined based on contributions into their personal pension accounts, plus accrued interest earnings. Both members and employers contribute to the account on a regular basis and these contributions are invested in stocks, bonds, mutual funds or other securities, at the member’s discretion. Unlike the defined benefits plan, employers are not responsible for managing investment assets, which can cause two members with the same work history and who retire at the same time to potentially receive different benefits payments.

The governor’s plan faced heavy resistance, mainly on the grounds that such plans make retirement benefits entirely dependent upon investment markets. Additionally, there’s been concern about the possible loss of survivor and/or disability benefits.

As the long-term consequences of population aging have become known the financing of entitlement programs has “one of the dominant issues in policy discussion and intervention in developing and transition economies” (Casarico 344). “Most developed countries operate some form of unfunded or pay-as-you-go social security system for providing old-age, survivor, and
invalidity benefits” to provide for financial security for retirees (Samwick 270). What has happened in recent years is that “too few participants who work under private pensions plans actually get a pension, and too many who work long…years get nothing” (Cummings 81). This isn’t the result of “evil men with bad motives” but rather because of “badly designed plans…” (Cummings 81). Much of the literature regarding pension reform focuses on two broad areas: recommendations and case studies from other countries.

Many industrialized countries have been facing “declining fertility and rising life expectancy…which will radically alter the future demographics, much like here in the United States (Fehr 420). Latin America “embarked upon a ‘personal pension stamped’” during the 1980s and 1990s, after Chile reformed its pension system. Chile’s plan, however, “has not lived up to expectations” for several reasons: the plan didn’t account for increasing numbers of women entering the work force, its coverage is actually lower than the plan it replaced, and only about 55% of the labor force is actually enrolled in the plan (Barrientos 319). Meanwhile, in Ontario, Canada, they were also forced to revise their pension programs after about a decade under which the previous plan wasn’t performing adequately. It became realized that there was a “need for better and more specific measures to protect the interests of employees in pension plans…” (Balcer 653). As in American federalism in which states can play the role of experimenter, the United States (and our fifty states) can look upon the successes and failures of our countries to help guide the process of reforming our pension plans.

In addition to outside examples, many scholars have conducted extensive studies and have all made several broad recommendations. David Blake has suggested that, not surprisingly, what type of pension scheme you have actually does matter. Currently, “funding provides greater
potential pension security than [pay-as-you-go]…which has become an increasingly unreliable vehicle for delivering the pension promise…” (Blake F77). However, should a government wish to maintain the pay-as-you-go system, “this can only be achieved by severely constraining the real growth rate in state pensions or by systematically raising the retirement age…”. Blake concludes by stating “the greatest impediment to having a decent pension in retirement is inadequate pension savings made during working lifetime.” (Blake F78). So, while a state or national government can have some success in helping it’s citizens prepare for later life, it still seems the burden of providing rests with the individual. Other recommendations for reforming pensions include “insurers, banks, employers, and unions…will have to develop a broader conception of the role private plans and recognize responsibility to achieve their potential. (Bernstein 26). Bernstein concludes by saying, if this does not happen, private plans will take their place in history “alongside the dodo bird…” (Bernstein 26). Assar Lindbeck claims there is a need “for basic, or guaranteed, pensions…” and that “growing reliance on quasi-actuarial and actuarially fair systems, which…do not encompass any systematic intra-generational redistributive elements, makes it even more imperative to maintain a safety net to prevent poverty in old age” (Lindbeck 109). However, it seems safe to assume, according to Roger Charlton, that “even mandatory requirements for worker affiliation to private pension schemes may neither prove to be the magic ingredient for ensuring rapid financial system deepening nor provide the guaranteed impetus to coherent private sector development that is expected” (Charlton 1440).

All in all, the pension reform dilemma is a complicated one, with few, if any, definitive, positive solutions. It will most likely take much trial and error, but with one added benefit: on the
global stage, there are many examples of pension reform successes and failures for which to emulate, tweak, or ignore as a government sees fit.

**Bibliography**


Researcher Nicholas Barr analyzes guaranteed funded pension plans against pay-as-you-go (PAYG) plans. The major problem facing PAYG plans is demographics. Because of aging populations in industrialized nations, especially the US, there is a distinct possibility that working age populations will not be able to sustain payments to retirees. He runs through a list of myths related to both funded and PAYG systems, and concludes that a mixture of the two systems through various “tiers” of pension funding is the best system (Barr 2001).

Barr continues his myths of pension reform series in another article that focuses on policy choices in pension reform. Barr again suggests that the differences between PAYG and funded pensions are a wash. Both have strengths and weaknesses, and both can be effectively used, as long as they are effectively managed, and used in the correct economic circumstances (Barr 2002).

Assar Lindbeck and Mats Persson continue in the same vein as Barr, and analyze differences in both defined benefit and defined contribution pensions, and funded and PAYG systems, adding the dimension of “actuarial fairness,” to discuss generational differences in pensions. The researchers weigh the pros and cons of various systems and again find that a balanced portfolio of diversification is the best system (Lindbeck and Persson 2003).

Andrew A. Samwick continues the trend of analyzing PAYG and funded pension systems, this time across 25 countries, and attempts to find which leads to a higher savings rate. Arguments for PAYG suggest that it would lead to higher levels of savings, due to the feeling of ownership offered to the investors. Instead, Samwick finds that PAYG systems lead to lower levels of savings. He suggests that countries that move from PAYG to funded systems should
finance the change through taxes, rather than increased debt spending. This reasonable step will lead to higher levels of national savings in the long run (Samwick 2000).

Armando Barrientos examines the possibility of a gender gap in pension coverage and examines the Chilean scheme of pension reform. He finds that women in Chile after the reform actually had higher rates of coverage than men. Again, demographics are an important lens of pension reform. Women are living longer than men, which will cause potential problems in the coming demographic crunch of more retirees than workers. He believes that personal pension plans would not necessarily increase the gender gap in coverage because it might best line up with women’s pension preferences (Barrientos 1998).

Richard Disney examines the future liabilities faced by industrialized countries in continuing to fund their pension programs at current levels. Many countries face unfunded mandates, which means current employees, current retirees, or future employees and retirees will bear the financial burden for maintaining current projections. Beyond demographic factors, Disney notes the propensity of countries to have “underpredicted improvements in longevity and overpredicted future fertility rates.” There is no one correct route to reform, although he does recommended funded pensions (Disney 2000).

Robert Holzmann analyzes the World Bank’s approach to pension reform and finds that overall, it supports a “multi-pillar” approach to pension reform, drawing on multiple reforms to PAYG and funded pensions. Again, an important aspect is the competence of a given government, the World Bank is more likely to help and give loans if the policies are not “self-defeating.” The importance of a multi-pillar approach is diversification. Pension reform should shift risks to multiple areas, rather than leaving all of the eggs in one basket (Holzmann 2000).

Another group of researchers analyzes the trade-offs incurred in collective bargaining
agreements between wages and pension funding. They use a set of data for 98 collective bargaining agreements in Canada and find that there are significant trade-offs between wages and the “flat benefit rate” in pensions. This can lead to incentives where workers can game the system and receive higher pension returns through early retirement, or lose out on surplus pension funding if they work past the “normal” retirement age (Gunderson, Hyatt, and Pesando, 1992).

Hans Fehr studies the impacts of pension reform in relation to Germany’s “demographic transition.” Again, demographic changes to an industrialized economy where rising life expectancy and lower birth rate levels will have strong effects on a country’s workforce. Germany faces a crisis in that the rates retirees will greatly outstrip employees paying into their pension system, which could drastically raise the amount of contributions necessary to maintain equitable benefits. If the retirement age is raised, it could help in the short term, but the researcher again suggests a multi-tier approach, focusing on a “variable benefit option” (Fehr 2000).

Karen M. Anderson engages in a comparative analysis of three small countries’ pension plans: the Netherlands, Sweden, and Denmark. Anderson analyzes the party politics of each country, and finds that Sweden created a publicly funded pension program due to the Social Democratic party hegemony. The Netherlands and Sweden both lacked strong left parties, instead the moderate and liberal parties in both countries created a system with a flat base of public funding, with Denmark’s supported by private market pensions, and the Dutch model supplemented by private, mandatory investments. However, all three countries’ pension programs created very similar outcomes based on social justice (Anderson, 2004).
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Pension Reform Literature Review

The case study from the Kennedy School of Government brings to light many issues associated with California’s current troubles with their state worker pension system. It is a complex problem with numerous stakeholders who would be greatly affected by Governor Schwarzenegger’s plan to change the pension system from a defined benefit system to a defined contribution system.
Pension reform is a problem that has an international scope. John Bongaarts in a March 2004 volume of *Population and Development Review* discusses the problems of pensions and social security that afflict a number of developed nations, including the United States. The main problem is related to the aging population and its effect on the pay-as-you-go system, similar to the defined benefit system in California. Bongaarts urges reforms in the pension system due to expected increases in pension expenditure as the population of a country ages and the burden is placed on the younger generations. One of the main obstacles to complete reform of the system, however, is transitional consequences from pay-as-you-go (defined benefit) to a fully-funded system (defined contribution). An alternative to reform to avoid some of the political consequences of such a shift could be to slightly alter the current system, but overall, leave most of its systems in place.

The choice of maintaining the status quo and rejecting an overhaul of the system would require some mild reforms in order to ensure the health of the pension system. According to Peter Diamond from *The American Economic Review*, the system of pay-as-you-go is a needed system that requires just a few changes, such as benefits payout decreases and tax increases that would eventually be balanced out as the economy grows in the long-run. A similar proposal is echoed by David Blake in *The Economic Journal* if a pay-as-you-go-program is maintained. In addition to his agreement with Diamond in the case of a pay-as-you-go system, Blake suggests the use of human capital investment to improve the system as well.

Keith Banting in *Canadian Public Policy* proposes including extra investment in the education of children and continuing education for current workers. He theorizes that the eventual result would be a workforce better able to sustain employment and generate higher incomes. His argument is based on some of the minor gains made in Canada’s system. He cites the only problem being an equal access to educational opportunities, which further emphasizes the need for more education investment.

In addition to investment, Robert Shiller in *The American Economic Review* suggests a greater use of information technology to better estimate the future needs of benefits recipients. While he does suggest an end to the pay-as-you-go system, his suggestion is still relevant in that better estimates through the exploitation of information technology may allow for decreased costs to the pension system and a more equitable disbursement of payments to all recipients.
To further emphasize the possibility of leaving the current system unchanged, at the moment, Luzadis and Mitchell, in *The Journal of Human Resources*, found that pension systems offered by private firms tend to change anyway, but in increments, as time passes. This could be a suggestion actions to those in charge of government pension systems, such as California’s, could take that could be undertaken in order to keep transition costs low and still institute reform.

Sources:

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**Pension Reform**

As America goes forward in the twenty-first century, there is an increasing generation of baby boomers reaching the age of retirement. Many of those who are reaching this age are more than likely to have a stable source of income after their career due a savings plan such as a pension. Pensions are a form of income by which many Americans will rely upon once their careers have ended and have continued to move on with their lives. However, there is a growing concern by many that the current pension system is inadequate to meet the growing needs of the population. Many policy-makers have attempted to pass pension reform legislation in hopes of
alleviating a growing problem that future retirees will face. In spite of these attempts, there are a myriad of groups that are opposed to any type of reform citing that any changes will only contribute to the fall of the system.

California is one such state that has attempted to pass some form of legislation in regards to pension reform. On January 2005, Governor Schwarzenegger offered several solutions to the growing fiscal problems of the state one of which was pension reform. According to the proposal, it would allow existing pension plans to remain without any new changes meaning individuals would continue to be paid annual pension payments. Employees hired after January 2007 would be enrolled in a different plan similar to that of a traditional 401k (Iammartino 1). This new plan would allow for more choice in investing the funds, but it does not guarantee set annual payment, as does the current pension system.

The current pension system operates under a defined benefit plan which ensures annual pension payments are given to the retiree on a periodical basis. These payments continue to be paid until the member passes away or opts for a different plan. Both the employer and the employee pay into the system during their tenure with the company (Iammartino 4).

Under a defined contribution plan, both the employer and the employee pay into the system much like the previous one. However, the contributions made in part by the two are invested towards stocks, bonds, and other forms of security. Additionally, the employer has no obligation or role on how to manage the member’s portfolio. In sum, the overall pension of the individual is dependent upon investment decisions, and the amount of risk involved greatly increases with this pension reform.

Evidently, a defined contribution plan does not have to worry with members once they retire especially those who are able to live well past their expected age. Unfortunately, there is a
great amount of risk involved as opposed to a defined benefit plan which guarantees a specific amount to the member once they are of retirement age.

The privatization of the pension system has many opponents to it including labor unions. Conversely, there are many, especially conservatives, who believe plans such as a defined contribution plan have greater benefits in spite of the high costs. Foremost, it allows more choice in the distribution of income to the member. Traditionally, those with pensions are unable to decide where and how that money is being invested. Under the new plan, members are able to choose the best methods to invest which may lead to higher yields. This form of “fiduciary capitalism” grants more choice to the member while also may lead to the maximization of profits (Brennen 42).

Pension reform is not a recent phenomenon, and the most recent push for reform was in the 1980’s during the Reagan administration. Fiscal conservatives increasingly believed that the welfare responsibilities of the government must be curbed (Beland 204). As a result, the administration began an initiative to push pension reform as part of its agenda. Solutions such as raising the retirement age or changing the pension formula were some of many that were offered, but reform proposals were inevitably unsuccessful (Kato 104).

The Governor’s decision to reform the California pension plan is one of many alternatives to aid in the reduction of overall state spending. There are many risks involved with reforming the current system and those changes risk alienating many pension members. Whatever may be the case, pension reform is an issue that will continually be debated irrespective of the successes or failures each new proposal may bring. May we hope in the end that a variety of pension reform is one that will take into account all of the risk involved, yet allow members to have a reliable form of retirement savings plan after their careers have ended.
Politics of Pension Reform

The issue of retirement and pension reform can be contentious both economically and politically. States all over the country are now dealing with calls to reform pension funds that are costly, unfunded, and increasingly insecure. This is an issue that is not exclusive to the
United States either. Countries across the world are currently in the process of examining reforms to pension systems both public and private. This debate has become a conflict between traditional guaranteed pensions and the increasingly popular self managed investment accounts. In each case there are strong arguments for and against the plans; including, security, longevity, incentive to workers, and public costs.

These systems can be classified in two primary ways. First, there are defined benefits plans. These plans, “are guaranteed pensions of a given amount per year upon retirement” (Barnow 524). The amount is based on a formula derived from a rage of criteria that varies between plans but commonly include length of service and a profile of monetary compensation earned by the employee over the range of employment. Second, there are defined contribution plans in which the employee contributes a certain amount of their income each pay period and is given various options to invest that money in a variety of funds. There are tradeoffs to each approach and with the increasing number of looming retirees and a population of workers that is not going to grow at the rate of baby boomer retirements states and corporations across the country are scrambling for solutions. California is just one such example. Starting with employees hired in July 2007 California Governor Arnold Schwarzenegger has proposed converting California’s two largest pension funds from defined benefits funds to defined contribution funds. This has led to intense debate in the California legislature and in municipalities, union halls, and staff lounges across the state. There are certainly a vast number of studies that can guide the state of California and other states in deciding on a solution to the pension problem that suits the needs and conditions of their economy and population.

There are, in fact, a number of ways that defined benefits plans are an advantage to the employee and the employer. Considering these advantages and a few modifications of the
current system that may increase efficiency and decrease state costs before dismantling defined benefits altogether would be a wise decision. Examples from the state of Florida and from Canada show some advantages of not totally abandoning the idea of defined benefits. As Hannah Glover comments, “Though defined-benefit plans may be going the way of the dinosaur, it might be a little early to call in the taxidermists…though the number of workers enrolled in traditional defined-benefit plans dropped roughly 27% [in 2005]” (1).

There is a strong feeling in a great deal of the literature that defined benefit plans are excellent options and have strong positive characteristics. Don Ezra, the director of strategic advice at the Russell Investing Group and Robert Brown of the University of Waterloo both conclude that defined benefit plans are not the problem in our current struggle with pension reform. Both point to government implementation of the plans (Ezra 28, Brown 67). Echoing these feelings is Nicholas Barr of the London School of Economics who believes, “The key variable is effective government. From an economic perspective the difference between pay as you go and funding is second order” (3). What, then, is the problem? What is it that the United States and public entities within the states are including in their direct benefit plans that are causing problems if it is not the plans themselves that are flawed? The answer is commonly seen as the way that plans are funded and utilized. Defined benefit plans in the United States have been over-legislated with contribution ceilings and as subsidies for economic planning in the workforce by giving early retirement incentives or investing in other areas of the public sector. When these ventures fail to deliver return companies and public interests tended to turn their backs on defined benefit plans. In reality, it was not the plan itself that failed but rather how the plan was managed by the government or corporation (Ezra 28).
Looking at Canada specifically there is an interesting contrast between the American trend of moving into defined contribution plans and Canada’s widespread refusal to abandon defined benefits. Robert Brown and Jianxun Liu explain this divergence in retirement planning in their paper “The Shift to Defined Contribution Pension Plans: Why Did it not Happen in Canada?” Brown and Liu point to three main reasons that Canada is different than the United States. Looking at these differences would certainly help the people and government of the State of California decide what is best for them and their posterity. First, they claim that the U.S. workforce is much more mobile, even transient, than the Canadian workforce. Workers shift in and out of the private and public sectors, cross fields as technology changes, and have little loyalty to companies. Brown terms this the “rational self-interest of workers” who increasingly wants to control their own retirement accounts as they move in and out of jobs and work for multiple companies throughout their careers (67).

The second problem is that this transience rate makes employers in the United States risk averse. Uncertainty in both the workforce and in the markets make employers seek to minimize costs by switching to defined contribution plans. It also leads to a host of other discriminatory possibilities. Burt Barnow argues that two problems in defined benefit plans are, “firms with more generous pension plans would…lower wages…and have an incentive to ‘encourage’ employee turnover by varying working conditions and other non-wage characteristics of employment” (535). This argument leads one to conclude that age discrimination, lower wages, and higher turnover in the job market will result from direct benefit plans. This may be true in the private sector and in that setting it may not even be a negative consequence from the point of view of saving defined benefit plans. However, in the public sector, such as CalPERS these are not cost savings options since there are union contracts, civil service protections, and a host of
other guarantees in place to prevent the state from taking such actions. Thus, this still serves as a problem for public pensions that have little recourse to lower costs without moving to define contribution plans.

Finally, Brown and Liu contend that excessive regulation of defined benefit plans in the United States hurts the effectiveness of such plans in ways not seen in Canada. Perhaps this could be an opportunity for public sector plans to improve efficiency without limiting benefit. Strict funding requirements passed in 1974 combined with complex tax law and often costly and time consuming accounting requirements make the plans inflexible and less attractive to employers, even public employers (68).

Defined contribution plans that offer employee control and take much of the burden off of the employer for providing retirement income are becoming increasingly popular in the United States; several companies and states are discussing the possibility of moving toward these plans. California is just one of a number of entities looking at defined contribution options. The goal of this move is two-fold. First, it supposedly reduces costs to the employer (though there can be substantial management costs) and second it gives more freedom to worker who can easily track their retirement, carry savings with them to new jobs, and decide on the level of risk they are willing to take with their future income. California needs only to look across the country to Florida for an example of how workers may react to defined contribution plans. In Florida, workers were given the option of opting out of the defined benefit plan in favor of personal management accounts. The state offered a “buy-back guarantee” in which they can switch their choice once during their employment. In studying this plan it is found that short-term employees enjoyed the defined contribution plans and long-term employees or those close to retirement prefer the defined benefit plans. The truly interesting lesson is that a buy-back
program may win over the public but it can be even more costly to the state than simply keeping a defined benefit program, especially if employees begin with defined contributions and then exercise their buyback option at an optimal time (Milevsky 12). While the goal of this move in Florida was to reduce costs to the state the result was far from what they expected and should serve as an example of what not to do in California if the goal is simply to reduce state costs.

Many scholars question the decision to move to defined contribution plans at all. They see this move as risky and without real benefits. Nicholas Barr responds to the benefits of increased choice claim of defined contribution plans by pointing out that this requires a well informed worker. Even the well informed are not guaranteed to be successful in these plans which leads one to wonder why anyone would choose defined contributions over defined benefits. James Dulebohn and Brian Murray claim that the benefits package preferred by a worker actually says something about the employee. This is important to states who are trying to simultaneously cut costs and still attract the type of worker that is needed. Workers make employment decisions, in part, based on benefits and those who are more stable will be attracted to employment opportunities that offer long term financial stability. The argument is that less risky employees who are willing to invest more time, energy and devotion to their employer tend to desire defined benefit plans (405). The age of the worker and earnings potential are other key factors in this choice with younger workers and higher earners choosing defined contributions initially but wanting to switch into defined benefit plans as their career plateau (Clark 29, Cocco 8).

The question that California’s legislature, governor, and public employees must answer given the literature and studies discussed above is what is their goal, what costs are they willing to incur, and how much risk are they willing to tolerate. Florida’s buyback program is popular, it
provides safeguards to risk, but it is potentially very costly. Given the current state of California’s budget it is unlikely that this is a viable option. Looking to Canada may indicate that decreasing government regulation may be a way to decrease costs to the state without dismantling the existing defined benefits plans but this is a process that involves changing state and federal laws and the results are far from predictable. States must balance the need to contain costs with their desire to attract a stable workforce and create a situation that does not leave retirees demanding supplemental programs after retirement. This is a delicate balance but it is important that we do not disregard the safety of defined benefit. Safeguards must be in place to prevent discrimination but this is more of a problem in the private sector than in the public sector where exit tends to be more voluntary. Prioritization is the first step in solving this policy challenge. Once a state has its priorities in place it can begin to design a plan that minimizes costs, maximizes employee benefits, and reduces risk to both the state and to employees.

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CALIFORNIA PENSION REFORM: LITERATURE REVIEW

INTRODUCTION

California’s two public pension plans are among the biggest in the world. Assets of each are both ranked in the world’s top ten1. The California State Teachers' Retirement System (CalSTRS) has a total membership of nearly 800,000 with assets of $159.5 billion. The California Public Employees' Retirement System (CalPERS) has a membership of 1,540,000 with assets exceeding $212 billion. Despite their size, however, benefit funding levels have seriously deteriorated over the past few years. In December 2006, under-funded liabilities totaled $49 billion2 for pensions and $70 billion for health benefits3. Combined, these liabilities continue to cost California

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taxpayers more than $3 billion a year - money that could instead be paying for programs like schools and public safety if the benefits were properly self-funded⁴.

For many, this under-funding came as no surprise. One year earlier, in 2005, Governor Arnold Schwarzenegger had backed the Fair and Fiscally Responsible Public Employee Retirement Act, an initiative designed to overhaul the pension funding provisions of both CalSTRS and CalPERS. His proposal, however, immediately met with stiff resistance from a broad "pension protection coalition" of twenty unions representing an estimated 2.5 million members. Public opinion ratings of Schwarzenegger’s performance soon showed a decline⁵. Consequently, the governor withdrew his plan⁷. Governor Schwarzenegger has since been reelected and in January 2007 formed a bipartisan commission to help address pension fund problems⁸. By January 1, 2008, the new Commission must submit their findings to the Governor and Legislature.

This literature review first provides a brief overview of how the CalPERS and CalSTRS systems function. It then explores perspectives of the under-funding debate within the context of pension reform. Academic literature addressing this specific issue in California is scarce. Most information has been found on the pension web sites and within California newspaper articles. Academic literature pertaining to pension plans in general is abundant and is referenced where appropriate.

⁷ Pension Reform in California. Institute of Governmental Studies, University of California – Berkeley. www.igs.berkeley.edu/library/htPensionReform.html
A BRIEF HISTORY OF CALIFORNIA’S PENSION PROGRAMS

Early precursors to modern pension systems in the United States originate with the colonial poor laws of the 1600s. These were fashioned after similar laws brought from England. The Poor Laws were followed in the 18th and 19th centuries by the creation of almshouses and poorhouses. Later, the Civil War produced a significant number of widows, orphans, and disabled veterans. Limited economic security was provided to these individuals through America’s first federal pension scheme.

Economic recessions of the late nineteenth and early twentieth century inspired numerous social movements seeking social insurance for all citizens. These include Huey Long’s ‘Every Man a King’ plan, Francis Townsend’s ‘Old Age Revolving Pension Plan’, Father Charles Coughlin’s ‘Union for Social Justice’ movement, Robert Nobles ‘Ham and Eggs’ scheme, and many more. In 1913 the California State Teachers' Retirement System (CalSTRS) was formed as an independent pension fund for state teachers. In 1932, California initiated a separate state employee pension plan now known as California Public Employees' Retirement System (CalPERS). These two systems continue to operate today.

VIEWING PENSION PLANS IN THREE DIMENSIONS

Pension plans are very complicated financial, legal, and administrative animals (Ney, 2000). To simplify understanding, Willmore (1999) suggests that they be viewed in three dimensions. First, plans should be viewed in the way they are financed. Pensions are either funded or unfunded. In Funded pensions systems, contributions are held in a capital fund which pays pension benefits. Contributions made throughout a worker's career help fund that same worker's benefits.

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9 Historical Background and Development of Social Security. [www.ssa.gov/history/briefhistory3.html](http://www.ssa.gov/history/briefhistory3.html). Most of the information found in my introduction comes from this source.
Remaining funds required are investment earnings on these contributions. Unfunded pensions (commonly referred to as Pay-As-You-Go schemes) on the other hand, pay current benefits with current contributions plus any investment returns. Contributions made throughout a worker's career help fund the benefits of those already retired.

Secondly, plans should be viewed by the way benefits are calculated. Pensions are either defined benefit plans or defined contribution plans. Members of defined benefit plans receive a guaranteed pension benefit but must pay variable contributions. Members of defined contribution plans, on the other hand, pay a fixed contribution while receiving variable benefits. Third, pension plans should be viewed by whether investment management is public or private. Lindbeck and Persson (2003) suggest a fourth dimension of microeconomic actuarial fairness, which refers to the relationship between contributions and benefits at the individual level.

Both CalPERS and CalSTRS are publicly managed funded-defined benefit plans. They have three sources of funding: Return on investments, employee contributions, and contributions by employers. The term ‘employer’ here refers to the State of California. California contributes varying percentages for employees based on their salary and the State's current economic health. During a stock market boom, State tax payer contributions are low. In times of economic slowdown they are high. In addition, the California Pension Obligation Financing Act, which was signed into law by the Governor on May 5, 2003, authorized the issuance of bonds and the creation of ancillary obligations for the purpose of funding or refunding the State's pension obligations.

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CalPERS’ retirement benefits are formulated on service years, retirement age and final compensation at retirement. CalSTRS retirement compensation is based on the highest average annual compensation earnable for 12 consecutive months if the member has 25 years or more, if less than 25 years or 36 consecutive months total service.

**TWO REASONS FOR UNDER FUNDING**

There are two fundamental reasons for California’s pension under-funding. The primary reason is stock market performance and related investment decisions. For example, when the markets turned sour after the dot-com bust, funding ratios fell sharply, a situation California plans are still trying to crawl out of\(^\text{11}\). Moreover, pension fund investments have not managed to match benefit commitments despite a CalPERS 15.4% return in 2006 and a CalSTRS return of 16.6%\(^\text{12}\).

The second reason for under-funding stems from major benefit increases signed in 1999 by former Governor Gray Davis. Benefit increases enacted under Davis account for $600 million of the current $2.6 billion annual payment, which leaves the stock market's decline as the main reason for the state's increased payment\(^\text{13}\).

**FIVE ARGUMENT FAVORING PENSION REFORM**

Through initiative, Governor Schwarzenegger proposed a constitutional amendment requiring California public employees hired after July 1, 2007 to participate in defined contribution plans rather than the current defined benefit plan scheme. Pre-existing employees would be able to

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maintain the status quo or convert to the new format. Retirement age would be increased from 55 to 65. This initiative was entitled The Fair and Fiscally Responsible Public Employee Retirement Act. Concurrently, two additional initiatives proposing reform were also prepared. These included the *California Public Employee Pension Reform Act* and the *Portable Retirement Security act of 2005*. These were similar in content.

The following five points summarize the pro-reform position. 1) The cost of government employee pension plans threatened long term investments in education, infrastructure, health care, and public safety. 2) California has among the nation’s most generous public pension plans, providing some employees with more than 100% of their final year’s salary at age 50. 3) Creating defined contribution plans for all state and local government employees will eliminate new unfunded liabilities. 4) A limit to the amount of public agency contribution to defined contribution plans must be established. 5) Defined contribution plans allow employees to enhance their credit standing, control their assets, move pension assets from one job to another, and pass along remaining funds to their heirs.

**SIX OBJECTIONS TO REFORM**

The following six points sum up the anti-reform arguments. 1) In many ways, the reform issue mirrors the battle over Social Security in 2005. You have a Republican politician inventing a "crisis", in an attempt to privatize a secure working system with a risky and untried plan. 2) Reform is actually an attempt to undercut the influence of CalPERS as a corporate watchdog and curb its political activism. 3) Scrapping traditional public pensions will make it hard for California to hire and keep qualified workers. 14. UC faculty, for example, are typically paid

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about 14 percent less than their peers in similar systems, and guaranteed pensions have helped offset that in recruiting. 4) Union officials argue the proposal would strip employees of death and disability benefits. 5) Unions call the proposal an attack on labor that would undo the time-honored practice of rewarding public service with secure retirement. 6) Workers don't spend much time managing their investments. They do not have access to professional fund managers, whereas plans like CalPERS and Cal STRS, by contrast, employ highly paid professionals to manage pension fund investments.

An additional argument used to discredit the reform initiative involves distorting the significance of pension fund investment performance (over a 16% increase in 2006) and associated credit ratings (Moody’s AAA in 2006). These performance indicators distract attention from the fact that it is the California state budget that must make a variable contribution thus guaranteeing a good pension fund credit rating. Furthermore, it is the California state budget that is consequently at risk, and not the pension funds.

**SUMMARY**

As noted in the introduction, very little academic literature has been published that addresses this specific California reform issue. However, by researching historical newspaper articles and relevant web pages, it is possible to determine Governor Schwarzenegger’s justification for attempting reform. Likewise, one can establish a fairly clear picture of public opinion and

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response. Efforts to reform public California pension plans appear to have based primarily on the continuing under-funding ratio and its negative affect on the state budget. This fact seems undeniable since, in a general sense, it is both a national and global problem. Moreover, the condition was guaranteed by the California constitution, a situation Weimer and Vining refer to as *ex ante control*; namely inflexibility caused by civil service protection. A constitutional amendment was required, in order to change the status quo.

It is also clear from media research that the exceptionally broad influence of the pension firms CalPERS and CalSTRS and of unions (specifically law enforcement and fire fighting unions) quickly made reform efforts politically unfeasible. Ironically, eleven of CalPERS' 13 board members are union members, union officials or government officials who received or solicited contributions from unions. This condition falls under Weimer and Vining's definition of *government failure*: specifically, posturing to public attention by distorting costs.

**REFERENCES**


