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Finding Better Solutions

The goals of the pension system are to provide secure and adequate retirement income. In both respects, the U.S. system needs better solutions. With the decline in defined benefit plans and the increasing reliance on 401(k) plans, future retirees will have less secure and less adequate retirement income than current retirees. Some analysts suggest the contrary—that 401(k) plans will provide adequate retirement income for most participants—but their studies do not take into account the developments in behavioral economics indicating all the problems that workers encounter in accumulating retirement savings through 401(k) plans.

This chapter summarizes the main policy implications from the book. It concludes by presenting a proposal for a new type of hybrid pension plan.

PUBLIC POLICY FOR 401(k) PLANS

Since the early 1980s, 401(k) plans have grown from being supplementary plans offered by plan sponsors who also offer a defined benefit plan to being the only plan that most workers have. However, the regulation of 401(k) plans has lagged in recognizing their important role.

One option would be to regulate all 401(k) plans as if they were primary plans, providing equivalent regulatory protection as that provided for defined benefit plans. A less burdensome, but more complex, approach would be to change the regulation of 401(k) plans so that two types of 401(k) plans would be recognized.

First, 401(k) retirement plans would be plans that are the primary or sole plan provided by an employer. These plans would be regulated as retirement plans rather than as saving plans.[1] The policy goal of leveling the playing field between defined benefit plans and 401(k) plans would apply to these plans. For example, these plans would be required to offer annuities, perhaps having as the default that 50 or 75 percent of the account balance would be annuitized as a joint and survivor annuity, or having the option that the annuity would begin at an older age, such as at age 80. These plans would also be required to frame the benefits as an annuity, providing the annuitized value of the account balance for retirement at different ages each time the account balance was reported to the participant. Tax changes could be made to encourage annuitization through 401(k) plans. Such changes could include providing less favorable tax treatment to lump sum payments through 401(k) plans. Alternatively, people choosing a lump sum could be charged a penalty that would be returned to the plan to subsidize the annuities of those taking them. This would be done to offset adverse selection.

The second type of 401(k) plan would be 401(k) savings plans. These would be 401(k) plans offered by employers that also offered defined benefit plans meeting minimum standards as to generosity. These plans would continue to be regulated as they currently are, reflecting their historical roots as secondary plans that are offered to supplement defined benefit plans. Having this two-tier regulation of 401(k) plans could encourage employers to offer defined benefit plans, since that would permit them to offer 401(k) plans meeting less rigorous standards.

A retirement income system based on workers making investment decisions clearly has problems. The U.S. educational system does not prepare most people for making investment decisions. Participants in 401(k) plans tend to make financial mistakes. Many participants lack both knowledge and interest. They fail to contribute, and those who do contribute do not take full advantage of employer matching contributions. They frequently make what appear to be inappropriate investment choices. While defaults relating to workers' choices to participate, contribute, and invest in 401(k) plans may not be optimal for all workers, such as short-tenure workers, they help assure that more workers will accumulate assets in a 401(k) plan, which are then available to finance retirement consumption. The effects of the defaults on women, minorities, and low-wage workers, in particular, deserve further attention.

Some investment experts believe that low-cost index funds are the best choice for many pension participants and other individual investors. According to one proposal, 401(k) plans would be required to offer as an investment option a low-cost index fund.

Participants in 401(k) plans bear the investment costs and typically also the administrative costs of their 401(k) plans. Yet many participants are unaware they are bearing these costs, and most do not know how much they are paying in fees. Fee disclosure to participants would be greatly improved if the fees they paid in dollars for administrative expenses and investment expenses, as well as the expense ratio for investment expenses, were disclosed on their annual and quarterly account statements. This type of disclosure is done in Australia for plan administrative fees and is done by the Janus mutual fund for investment costs.

A problem with defined contribution plans that has received relatively little notice is the persistency of contributions by workers. Many workers do not consistently contribute to their plans, resulting in reduced account balances at retirement. The lack of persistency accounts at least in part for the surprisingly low account balances that many 401(k) participants have at retirement.

A widely recognized problem with 401(k) plans is that few plans provide annuities, and when annuities are offered few participants take them. People may be reluctant to annuitize because a relatively large amount of money is involved in an irreversible decision. Addressing the first concern, one approach that might encourage greater annuitization is the laddered purchase of annuities, meaning that it would occur in small quantities over time. Doing it this way would reduce the interest rate risk, and it might reduce the reluctance of workers to annuitize, because the amounts involved in each transaction would be small. Laddering could be done within the context of a target retirement date plan, where typically the percentage of the worker's portfolio held in bonds is increased as the target retirement date approaches. An alternative would be to gradually purchase annuities as the retirement date approaches. Workers' reluctance to annuitize might be further reduced if that were the default option for the employer's contribution, starting at a fixed age, such as age 50.[2]

An alternative approach to encouraging annuitization would be to require that 401(k) plans report at least once a year to participants the amount of the annuity they would receive at current interest rates if taken at age 62. That approach would encourage employees to think in terms of taking their benefit as an annuity. An additional policy innovation would be to charge an exit fee when lump sum benefits are taken, and use that fee to subsidize annuities, offsetting the effect of adverse selection that occurs when people choose to take a lump sum.

To assure greater participation in 401(k) plans, those plans could be required to provide a reverse match. With a reverse match, the employer would be required to contribute a certain percentage of pay for each worker. Workers could then have the option to contribute to the plan up to a certain matching amount. With this policy, the coverage provided by 401(k) plans would be more similar to that provided by defined benefit plans.

Defaults can be used to improve the outcomes provided by 401(k) plans. They offer the promise of improving participation and having better investment outcomes for workers.

The current approach of tax deductions for pensions favors upper-income workers. An approach that would provide the same amount of incentive per pension dollar would be to provide tax credits.

PUBLIC POLICY FOR DEFINED BENEFIT PLANS

The decline in defined benefit plans is an issue of serious concern. A number of policies should be considered to address that issue.

Private sector defined benefit plans are the only major type of pension plan in the United States that does not permit employee tax-deductible contributions. Employee tax-deductible contributions are permitted for 401(k) plans, and for defined benefit plans for state and local government employees. Extending tax deductibility to private sector defined benefit plan participants would help level the playing field between defined benefit plans and 401(k) plans.

Transition issues arise concerning permitting employee tax-deductible contributions. Employers who instituted employee tax-deductible contributions would effectively be reducing employee compensation if they did not make compensating increases in wages. Nonetheless, employers already have the ability to reduce compensation by failing to provide annual pay increases while inflation erodes the real value of compensation.

While coverage in defined benefit plans has declined dramatically in the United States and even more so in the United Kingdom, the decline has been relatively modest in Canada and Ireland. Thus, international experience casts doubt on the view that defined benefit plans are dinosaurs and their decline and extinction is inevitable. In both Canada and Ireland, and indeed in most countries with defined benefit plans, employees make tax deductible contributions to those plans.

A factor that appears to have played a role in the decline of defined benefit plans has been the increase in life expectancy, as defined benefit plans do not have the flexibility to deal readily with this continued increase in cost. In the United States, some plans have adjusted downward their generosity, but generally this change is only done for new hires. A possible policy innovation, following the notional defined contribution plan in Sweden, would be to permit life expectancy indexing of benefits at retirement. Thus, for each new retirement cohort, the generosity of the plan would be adjusted downward slightly to reflect the trend toward greater life expectancy. Once workers are retired, further adjustments to their pensions for improvements in life expectancy would not be made. Under U.S. law, this innovation would not be allowed because it would violate the anticutback rule. The anticutback rule is defined in terms of annual benefits. If it were redefined to take an economist's perspective and use the present expected value of lifetime benefits as the measure, life expectancy indexing would not constitute a cutback in lifetime benefits.

Continued improvements in life expectancy mean continued increases in the cost of providing defined benefit plans. Sweden in its social security system has a plan, the notional defined contribution plan, where benefits at retirement are indexed for improvements in life expectancy. Each year, as another cohort reaches retirement age, the generosity of benefits is reduced slightly to take into account the continued improvement in life expectancy. The adjustment does not reduce expected lifetime benefits.

Life expectancy risk can be divided into the idiosyncratic risk that a particular individual will live longer than expected and the cohort risk that an entire cohort on average will live longer than expected. Annuity providers are able to deal with idiosyncratic risk by pooling it across large numbers of people, effectively diversifying it away. However, cohort risk cannot be pooled. Longevity bonds would provide a hedge, but a market for them has not developed. The higher the percentage of a cohort that is surviving, the higher the payout longevity bonds have. Life expectancy indexing of benefits is one way of dealing with this risk. The idiosyncratic risk is borne by the annuity provider, who can diversify it away. The cohort risk is borne by workers, who are the beneficiaries of the improved life expectancy.

This feature would shift onto workers the systematic life expectancy risk, which is the risk that an entire birth cohort will live longer on average. The plan sponsor bears the idiosyncratic life expectancy risk, which is the risk that a particular individual will live longer than expected.

With increases in life expectancy at older ages, a number of countries have raised the earliest age at which pension benefits can be received. Doing so has been part of a policy to encourage workers to retire at older ages.

Workers who change jobs or are laid off by their employers and who participate in defined benefit plans suffer benefit losses. They suffer benefit losses because their benefits are frozen in nominal terms at the point of job termination, and the real value of those benefits is eroded by inflation between that point and the point at which they qualify for retirement benefits. Plans can make these workers wait until age 65 to receive benefits. For laid-off workers, the loss of pension benefits can be more serious than the loss of wages, while for employers the loss of pension benefits gives them a bonus for laying off older workers.

One policy option is to require healthy firms that lay off workers in corporate restructuring to price-index the benefits of those workers until retirement. This requirement in a certain sense would not impose a new cost on employers. It just mandates that they pay the benefits to these workers that they had promised to pay.

Funding rules prohibit employers from contributing to defined benefit plans in years when those plans exceed a certain level of funding. These rules have the effect of prohibiting plan sponsors from contributing toward the increased liabilities of their plan in that year. This requirement of zero contributions in some years generally occurs when the stock market and companies are performing well. Because pension plans are long-term commitments and because of the fluctuations in the stock market, at a later date plan sponsors then are required to make contributions. That requirement generally occurs when the stock market and companies are performing poorly. This requirement not only increases the volatility of contributions, it forces plan sponsors to contribute on a time pattern that is exactly opposite of what they would desire.

To reduce the volatility and timing problem of employer contributions for defined benefit plan funding, both the maximum and minimum contribution requirements could be eased. First, plans could be allowed to contribute 25 percent of normal costs in any year, regardless of the level of funding. This proposal would set the floor on contributions allowed at 25 percent of normal costs rather than zero. Thus, plan sponsors would be allowed to make a contribution every year, the pattern desired for pension plans as ongoing entities.

To ease the requirements on the minimum required contributions, plan sponsors could be allowed a longer period over which to amortize unfunded liabilities. For example, they could be allowed a period of 15 years, rather than the current seven years set by the Pension Protection Act of 2006. Underfunding would be less of a problem if the proposal of raising the minimum allowed funding were enacted.

Employers sponsoring U.S. defined benefit plans are responsible for financing any shortfall, but they are unable to tap excess assets in the pension fund should the fund perform better than expected. Allowing employers to withdraw excess assets under certain circumstances would likely increase the willingness of employers to adequately fund plans and could also affect their willingness to offer defined benefit plans. However, it creates the risk that a firm might be taken over for the purpose of withdrawing excess assets from its pension plan.

The tax system could be used to encourage broader coverage through defined benefit plans. For example, to tie the interests of management to those of workers, the allowable maximum income considered for determining defined benefit plan benefits could be raised in plans that provided 100 percent coverage to all full-time workers. Other options linking the interests of management and workers would include the provision that employers that provide a defined benefit plan for management would be required to also provide a similar plan for employees.

In many large companies, the executives have completely different pensions from the workers and have no personal stake in the pension options of the workers. Linking proposals could require that companies that provide defined benefit plans for executives also provide defined benefit plans meeting minimum standards for workers. Similarly, if the company froze or terminated a defined benefit plan for workers, such a stipulation could require that it also do so for executives.

The Pension Protection Fund in the United Kingdom was established with a goal of learning from the experience of the Pension Benefit Guaranty Corporation in the United States. One of its innovations is premiums based in part on the risk of a claim being made.

The lost pension problem is a problem for workers who are laid off or who change jobs. While it is a problem in both defined contribution and defined benefit plans, it is more of a problem in defined benefit plans because they are less portable. It can be difficult to track down a pension from a former employer, particularly if that employer has gone out of business. Both the United Kingdom and Australia have gone further than has the United States in assisting people facing this problem. A national registry, perhaps one created by expanding the registry maintained by the Pension Benefit Guaranty Corporation, would be a major improvement in this area.

PROPOSAL: A NEW TYPE OF HYBRID—THE LIFE-INDEXED DB

Some of the policy innovations just discussed could be incorporated into a new type of hybrid plan called the life-indexed DB. This plan would have three features that would distinguish it from a traditional U.S. defined benefit plan. First, it would permit tax deductible employee contributions. Tax deductible employee contributions are permitted for defined benefit plans in the state and local government sector, and in Canada, the United Kingdom, and a number of other countries. This feature would lower employers' pension costs. To provide some protection to workers during the transition to this plan, the transition could require that employee contributions as a percentage of pay could increase by at most 1 percent in a year and that they could only be made in conjunction with a pay increase of at least 2 percent.

Second, the plan would have life expectancy–indexed benefits. This feature is present in all defined contribution plans and in cash balance plans when account balances are converted to annuities based on current mortality rates. With life expectancy indexing of benefits, when benefits are calculated at retirement age, a life expectancy adjustment factor would be applied to the benefit formula to adjust annual benefits downward so that increases in life expectancy that had occurred before retirement age would not lead to an increased present value of lifetime benefits. This change would shift part of the risk of improvements in life expectancy back to workers. Employers would retain the risk that life expectancy would improve at higher ages after a cohort had reached its early retirement age.

Third, laid-off workers with vested benefits in healthy firms would be protected against the eroding effect of inflation up to the date at which they would be eligible to receive benefits. Their benefits would be price-indexed from the date of layoff to their early retirement age. This change would protect workers and would take away from employers the actuarial bonus they receive when laying off workers. If a worker is laid off at age 51 and cannot receive benefits until age 65, the real value of those benefits is eroded by inflation occurring during that period. With this aspect of the plan, the wages of workers laid off would be price-indexed up to the point of retirement, and the price-indexed wages would be used in the benefit calculation. This way, firms would no longer receive an actuarial bonus for laying off workers.

This is a balanced proposal. The first of the three features would reduce employer cost. The second of the three features would reduce employer risk. The third feature would reduce employee risk.

CONCLUSION

Pension policy is an evolving product of our social institutions and our economy. With the decline in defined benefit plans and the increasing role of 401(k) plans, much remains to be done to improve the way pensions are provided to American workers. One improvement would be to fashion a system that includes new types of plans, such as defined benefit plans with employee contributions and life expectancy–indexed benefits. By making such improvements, steps can taken toward a retirement income system that provides adequate and secure benefits for all Americans.

Notes

1. Issues could arise if an employer offered more than one type of defined contribution plan, such as an employee stock ownership plan (ESOP) and a 401(k) plan. One approach to these types of issues would be to regulate all 401(k) plans as 401(k) retirement plans if the employer did not also provide a defined benefit plan that was not frozen.
2. This innovation was suggested by Mark Iwry in preparation of Iwry and Turner (2008).