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THE TROUBLE WITH PENSIONS: TOWARD AN ALTERNATIVE PUBLIC POLICY TO SUPPORT RETIREMENT

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Introduction

No one needs to be reminded that pension funds have taken a big hit over the course of the financial crisis. Private pensions have gone from being 109 percent funded in 2007 to 79 percent funded in 2008—meaning that the value of accumulated assets falls short of meeting promised payouts of defined-benefit pension plans by about one-fifth, a shortfall of $400 billion. The shortfall in public pensions provided by state and local governments is estimated to run as high as $2 trillion. By any reasonable accounting standard, the Pension Benefit Guaranty Corporation (PBGC) is troubled because its reserves will be wiped out by the failure of just a couple large firms with "legacy" pensions. There has been a long-term trend to convert defined-benefit plans to defined-contribution plans—which means that workers and retirees take all the risks. Indeed, this is often the outcome for "legacy" defined-benefit plans that require bailouts. In spite of some attempts to improve the management and transparency of pension funds, it is likely that the PBGC itself will need a government bailout, and that retirees now face a more difficult future.

In this policy brief we examine how we got into this mess—and how deep the hole is. More important, we argue that the current approach to managing pension funds leads to excessive cost and risk, both for covered individuals and for society as a whole. We advocate a different

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approach, one that would rely more heavily on government support for retirement through the expansion of Social Security.

How Did We Get into This Mess?

During World War II, government wanted to hold down wages to prevent inflation. Unions and employers negotiated postponed payment in the form of pensions, which pleased all three parties: big firms, big government, and big unions. Unions got to deliver decent retirement income to members—a useful recruiting tool. Government promoted this with tax advantages for contributions to pensions, and by pushing spending into the postwar years it reduced inflationary pressure. And firms loved postponing costs to an indefinite future. This meant that pensions could be paid only if the firm were successful for a very long time. It was the era of John Kenneth Galbraith's New Industrial State, when it appeared that the coalition of government, business, and labor interests could ensure preservation of market share and maintain the power both to set wages and to set prices at a level to cover wages as well as benefits such as pensions.

In the early postwar period, private pensions held nearly 60 percent of their assets in Treasuries and almost all the rest in corporate and foreign bonds. In recent years, however, equities plus mutual funds have come to make up the vast majority of holdings for both public and private pension funds. These funds represent about 70 percent of GDP and are huge relative to the size of the economy and the size of financial assets.

Defined-contribution plans such as 401(k)s and individual retirement accounts (IRAs) have become a major source of retirement income for many Americans. This has placed almost the entire burden of saving for retirement on workers, as there is no law requiring employers to match employee contributions to 401(k)s. A simulation by Boston College's retirement-research center demonstrated that even if a worker had contributed 6 percent of his pay to a 401(k) plan for 40 years, invested in a target-date fund, never borrowed from the fund until retirement, and invested in annuities at retirement, he could replace only 28 percent of his preretirement income, if he retired in 2008 (Laise 2009).

The Pension Protection Act of 2006 gave participants the opportunity to "exercise control over the investment of assets in their plan accounts"(DoL 2008) if the plan's fiduciary invested in one of the qualified default investment alternatives, unless otherwise directed by the beneficiary (DoL 2006). These alternatives moved away from stand-alone, fixed-income capital preservation vehicles and toward both capital appreciation and capital preservation. In other words, they are riskier but supposedly offer higher returns.

The recent decline of asset values both in absolute terms and relative to GDP has been historically large. Total losses of private retirement funds (including IRAs) are about $2.9 trillion (FRB 2009). The PBGC insures defined-benefit private pension plans, but its overall deficit approached $22 billion in 2009. Although the PBGC has enough liquidity to meet its commitments for the next several years, it is underfunded in the long term, and none of its programs have sufficient funds to meet their long-term obligations.

We want to be clear here: the PBGC is a government operation, like the FDIC, and as such it cannot go bankrupt. Rather, its long-term funding deficit or its shortfall of inflows can always be made up by Treasury payments. The point is that private as well as public (state and local) pensions are in trouble, and exactly how they will be bailed out will ultimately be determined by the Congress. Retirees will suffer not because of mistakes they have made but from pension shortfalls—shortfalls that are due to the "grand compromise" that allowed employers to only partially fund pensions, to the government's unwillingness to fully guarantee pensions, and to the government's and employers' willingness to allow pension fund managers to take risks with workers' retirements.

Pension funds are part of what Hyman P. Minsky called "managed money," and it could be argued that the global financial crisis actually resulted from the way that managed money operates (Wray 2009). Since World War II, managed money has become so large that it is capable of literally "moving markets" and destabilizing asset prices. A good example is the commodities boom and bust during the aughts; another is today's boomlet—which might be coming to an end. As explained in Wray 2008, the deregulation at the end of the 1990s allowed pension managers to invest in commodities for the first time. And when managed money flows into an asset class previously uncorrelated with other assets, that asset will become correlated. Hence, by marketing commodity indexes as uncorrelated assets, a commodities bubble ensued (one that was also fed by Congress's decision to mandate biofuels use) that would collapse along with everything else.

What is most important to see is that commercial banking has become increasingly irrelevant, as have other traditional lines of business such as thrifts and credit unions. Just before the current global crisis hit, pension funding was, on average, doing well—thanks to the speculative bubble. The crash caused the current underfunding. In order to restore funding levels, pensions need a new asset bubble. The problem, really, is that managed money is now too large to be supported by the nation's ability to produce the output and income necessary to support the financial assets and underlying debts. Hence, returns can be generated only by "financialization," or by layering and leveraging existing levels of production and income. This is why the ratio of financial assets and debts grows continually (much faster than GDP)—and why managed money has to continually innovate new kinds of assets in which to speculate, such as securitized life insurance policies that pay off when people die earlier than expected (see Auerback and Wray 2009).

It is worth noting the similarities between the U.S. health care and pension systems. Like pension funds that are controlled by money managers, our health care is largely managed by highly oligopolized financial firms (insurance companies) run by well-compensated executives (with Medicare and Medicaid providing a third leg—much as Social Security forms the third leg of the retirement stool). Workers have little control over their health care, which is frequently chosen by employers, and fees are passed along to the employee. With others in control, there is little to hold down costs—even as wages are sacrificed on the argument that workers are receiving valuable nonwage compensation. Health care "reform" could be seen as a partial answer, or as the further financialization of health care via mandates that individuals must buy insurance—effectively turning over more of the national income to financial institutions (in this case, insurance companies).

Pension Fund Strategy

Pension fund managers have a strong incentive to meet or beat the average return of pension funds, or else face getting fired; hence, they must take on more risk. But since higher returns only reward higher risk (and thus higher losses), with competitive markets the average fund manager will receive only the risk-free return. Thus, pensions would do just as well by investing in riskless Treasury bonds (plus, perhaps, the highest-rated state, municipal, and corporate bonds—essentially what pensions did in the initial period following World War II).

In financial markets, the institutions that create and market complex financial instruments are in effect the house, and the house always wins—as Satyajit Das (2006) and Richard Bookstaber (2007) show. Wall Street institutions manufacture risky assets such as securitized subprime mortgages and provide a wide array of hedging strategies to shift risk, as well as credit default "insurance" and buy-back assurances in case anything goes wrong. Moreover, these institutions charge fees for all of the instruments they are selling, ensuring that pension funds will on average net less than a risk-free return and be left with massive counterparty risk as the hedges, insurance, and assurance go bad.

An Alternative Public Policy Strategy

Workers would be far better off if their employers were obligated to fully fund pensions with investments restricted to Treasury debt. At most, each pension plan would require a very small management staff that could simply log on to www.treasurydirect.gov to transfer funds out of the employing firm's bank deposit and into Treasuries. Unlike pricing packaged subprime loans and derivatives, this is not rocket science. Good-bye, fund managers and Wall Street sales staff.

Indeed, this raises the question, Should the federal government promote and protect pensions at all? Since there is no strong reason to believe that managed funds will provide a net return that is above the return on U.S. Treasuries, it would be far better to remove the tax advantages and government guarantees provided to pension plans, and instead allow individuals to put their savings directly into Treasuries, which are automatically government-backed and provide a risk-free return.

The U.S. retirement system is supposed to rest on a three-legged stool: pensions, individual savings, and Social Security. Pensions are mostly employer related, and are seriously underfunded and directed toward defined-contribution plans. There are also huge and growing administrative problems posed by the transformation of the American workplace (e.g., the typical worker frequently switches jobs, and the lifespan of firms is measured in years rather than decades). The problem with private saving is that Americans do not save enough for their retirement, and they could be duped out of their savings by unscrupulous financial institutions selling risky investments.

Thus, the best solution would be to eliminate government support for pension plans and private saving, and instead boost Social Security to ensure that anyone who works long enough to qualify will achieve a comfortable retirement.

The U.S. financial system is still far too big even after the crisis. In our view, it makes no economic sense to send as much as 40 percent of corporate profits to the finance, insurance, and real estate (FIRE) sector, as we did at the peak of the bubble—and we seem to be restoring the sector's share even now, as the financial sector has rallied. Moreover, there is a concerted effort to convince Americans that Social Security is broke; but Social Security is a federal government program, and as such it cannot become insolvent (see, in particular, Papadimitriou and Wray 1999). All we need is a strengthened Social Security program with a government guarantee behind the promised benefits.

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