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Leverage, Linkage, and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Reform Debate

by Norman P. Stein

The argument for Social Security privatization is, at bottom, simple: we need more, and better, advance funding of the public retirement system. In particular, we need to commit a portion of FICA tax to privately managed investment accounts, which will purchase investment instruments that promise higher rates of return than the government debt instruments in which the Social Security surplus is currently invested. The debate on privatization has centered on whether Social Security faces an impending demographic crisis during the coming decades, whether privatization is fundamentally inconsistent with the idea of social insurance, whether privatization financial projections are accurate, whether privatization is a more rational means of investing in private investment markets than having the social security trust fund make such investments directly.

The privatization debate, however, has been peculiarly divorced from the reality that this nation already has in place a massive retirement system whose funding is almost entirely committed to private investment markets: the employment-based pension system. This employment-based pension system is sometimes referred to as the private pension system, although the adjective "private" is something of a misnomer: the federal fisc contributes mightily to the system through tax subsidies, and many employment-based pension plans are maintained by public entities for their employees rather than private-sector employers. This paper, however, uses the term "private pension system," because it focuses on the plans sponsored by non-governmental employers.

This paper attempts to advance the debate over whether to privatize, and if so how to privatize, Social Security, by reflecting on three of the private pension system's major problems and their relevance for the Social Security reform debate. I refer to these issues as ones of leverage, linkage, and leakage.

By leverage I refer to the widely accepted idea that the private pension system is intended to encourage employers to set up plans to create retirement security for their employees who would otherwise not save adequately for their years outside the labor markets. The structure that we use to accomplish this goal is to provide tax incentives for business owners and managers to establish plans for themselves and then leverage these incentives by regulations requiring the plan to also provide benefits for low- and moderate-income employees.

By linkage I refer to the idea that there should be close identity between the retirement benefits employees reasonably expect to receive under their retirement plan and what they actually receive. And by leakage I refer to the idea that pension plans are designed to provide retirement incomem and plan assets should not leak out of the plan for non-retirement purposes. The private pension system, in my view, has a inadequate leverage and linkage and an alarming degree of leakage.

Reflecting on these problems with the private pension system can inform the Social Security reform debate in two significant ways. First, to the extent that Social Security and the private pension system are understood as two components of a unified national retirement policy, they should work in complementary fashion to produce a coherent policy result, one that addresses the income security needs of all, or almost all, of the nation's nonworking aged population. From this perspective, Social Security should backstop the weaknesses of the private system and satisfy objectives not adequately addressed by it. Second, the private system, because it is a funded system similar in some ways to proposed privatization models, may hold some lessons for how a privatized system should be designed if it is to be designed at all.

The first section of this article provides a brief historical overview of the private sector pension system, and government regulation of that system. The next three sections of this article discuss the problems of leverage, linkage and leakage in that system. The fifth section of the article explores the meaning of these problems in the private pension system for the Social Security reform debate.

I. Overview of the Private Pension System and its Regulation

The private pension system in this country is generally traced to 1875, when the American Express Company began a pension plan for its aged, long-tenured disabled former employees. By 1929 there were approximately 300 pension plans, the great majority of them supported solely, although with inadequate funding, by the sponsoring employer. (Many of these plans failed during the great depression.) These plans generally required substantial service and work until retirement for an employee to receive benefits, and even then benefits under the plan were generally considered gratuities from the employer and cancellable at the employer's option. In a parallel development (commencing in the early 20th century), some employers established individual account deferred compensation plans for their employees, generally but not always for the purpose of sharing firm profits.

The passage of the income tax presented the new problem of how pension and profit-sharing plan contributions, investment income, and payment of benefits should be treated for tax purposes. Over the first two decades of the income tax Congress established a regime under which employers received immediate deductions for contributions to pension and profit-sharing plan trusts; the trusts themselves were exempt from tax; and employees received income only upon receipt of benefits. This created a tax-favored environment for such plans, which Congress, in the Revenue Acts of 1938 and 1942, began to limit to plans that satisfied certain regulatory requirements.

The first such requirement limited the employer's rights to terminate a plan and recapture plan assets. Prior to 1938, the revenue laws had permitted employers to deduct contributions to revocable pension trusts and terminate them at will at some later date.[1] At the time, state laws generally defined participant rights to future benefits as gifts that could be cancelled by the employer at will or as unilateral contract rights that vested only when an employee retired at or after a specified age.[2] The employer could, of course, depart from this understanding of employee benefit rights by drafting a plan to confer contractual rights on participants, but this rarely occurred.[3] Since few plans had many employees with fully vested rights in their accrued benefits, an employer who terminated a pension plan could often recover most of the plan's assets.

From the employer's standpoint, the discretion to terminate a pension trust may have been an important tax planning tool, for the revenue laws made no provision between

[1] This section is largely adapted from Norman P. Stein, Reversions from Pension Plans: History, Policies, and Prospects, 44 *Tax L. Re*v. 259, 279-282 (1989). For still more historical background on the development of the restrictions on reversions of surplus assets to the employer, see Norman P. Stein, Raiders of the Corporate Pension Plans, 5 *Am. J. Tax Pol'cy* 117 (1986).

[2] See note 24, supra.

[3] See Latimer, note 28, supra, at 743 (of 397 employer funded pension plans studied, only nine created vested right to benefits based on service along; employee would forfeit benefits if employee left service prior to retirement age).

1933 and 1939 for the deduction of net operating losses.[4] It has been suggested and seems likely that an employer who had a net operating loss for a year would have considered terminating its pension plan to recover the assets and create income to absorb the loss.[5]

In 1937, following a presidential statement and hearing on various methods of tax abuse, including tax-motivated pension manipulation,[6] a House Ways and Means subcommittee began to study ideas for revising the law laws.[7] One of the subcommittee's concerns was the revocable pension trust: :

> A special method of taxation is provided for such a [pension] trust. . . . There is no requirement at present that the trust be irrevocable. It is evident, however, that the employer should not be allowed a deduction for amounts which are still within his control, and subject to recapture, through a power to revoke the pension trust.[8]

The subcommittee proposed requiring the irrevocability of a pension trust as a condition for status as a plan qualifying for favorable tax treatment. The House version of the Revenue Act of 1938 followed this recommendation; it would have included as a qualification condition the following language: "under the trust instrument it [must be] impossible for any part of the corpus or income to be . . . used for, or diverted to, purposes other than the exclusive benefit of" the employees.[9] The language would have made it impossible for plan assets ever to revert to the employer.

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[4] See National Industrial Recovery Act, § 218, 48 Stat. 195 (1933) (repealing § 117).

[5] See e.g., Alicia Munnell, *The Economics of Private Pensions* 32 (1987); Goodman, note 85, supra, at 228; Amoroso, note 2, supra, at 1-10.

[6] Tax Evasion and Avoidance, Hearings before the Joint Comm. on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 32 (1937); see also, George T. Altman, Pension Trusts for Key Men, 15 *The Tax Magazine* 324 (1937).

[7] House Comm. on Ways and Means, Proposed Revisions of the Revenue Laws 1938, 75th Cong., 3d Sess 32 (1937).

[8] Id. at 56.

[9] H.R. 9682, 75th Cong., 3d Sess. 175 (1938).

While the report of the House subcommittee noted that its proposed amendment would encourage “the formation of pension trusts upon which employees can rely with assurance for support upon retirement,” the amendment was designed to deny the employer “a deduction for amounts which are still within his control, and subject to recapture.”[10] The principal motivation for the proposed amendment was the prevention of tax manipulation.[11]

The Senate Finance Committee, apparently in response to employer lobbying, made a change to the House bill which it “deemed advisable in fairness to the employers.”[12] The Finance Committee explained its concerns:

> It is quite possible that after the satisfaction of all pension liability under the trust, an additional amount of funds of the trust will remain, due to erroneous actuarial computations during the previous life of the trust. It seems desirable to allow the employer to provide for the return of such an amount in the trust without the trust losing its exempt status under section 165(a)(2).[13]

The Committee thus modified the House language to make diversion “impossible at any time prior to the satisfaction of all liabilities under the trust.” The House accepted the Senate changes at conference, and the non-innurement principle, albeit a weaker version of it than the House had proposed, became part of the revenue laws.

The second requirement, or rather set of requirements, created the nondiscrimination principle for qualified plans. Prior to 1942, the Internal Revenue laws required only that pension plans benefit all or some employees of a firm.[14] Some firms accordingly adopted plans whose coverage was limited to a small number of shareholders and highly paid managers, who stood to

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10 Proposed Revisions, note 88, supra, at 56.
11 Revenue Act of 1938, Hearings on HR 9682 Before The Senate Comm. on Finance, 75th Cong., 3d Sess. (1938).
12 S. Rep. No. 1567, 75th Cong., 3d Sess. 24 (1938).
13 Id.

benefit mightily from the tax deferral generated by pension and profit-sharing plans.[15] The Department of Treasury regarded these plans as little more than tax shelters serving no social purpose and proposed a variety of requirements for employee deferred compensation plans, including nondiscrimination rules.[16] In 1942, Congress responded to Treasury's concerns by enacting two related sets of nondiscrimination rules: first, minimum coverage rules, which required plans to cover at least some rank-and-file workers; and second, benefit and contribution nondiscrimination rules requiring that covered rank-and-file employees receive either benefits or contributions comparable, as a percentage of pay, to the benefits or contributions of officers, shareholders and other highly compensated employees.

There are three ways of viewing the Treasury proposals and Congress's intent in adopting them: first, as a means of curtailing the use of pension plans as tax shelters covering only key employees (Treasury wanted to limit the tax abuse it found inherent in an employee retirement plan covering only key employees); second, as a means of reserving a tax subsidy for plans that provide some social benefit; and third, as a means of affirmatively encouraging the formation of pension plans that provide such benefits.[17] Historical evidence exists to support

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[14] *See* § 165, Revenue Act of 1935.

[15] *See* George T. Altman, *Pension Trusts for Key Men*, 35 TAXES 324 (1935). Two cases before the Board of Tax Appeals approved plans that provided benefits only to a group of highly paid individuals. *See Moore v. Comm*'r, 45 BTA 1073*; Harris v. Comm'r*, BTA Memo Opinion, 1939 P-H BTA Memo Dec. 39,472 (1939).

[16] The Treasury initially promulgated regulations that cautioned about the use of nominal pension trusts to reward officers and owners. Regulations 94, Article 23(p)-1 ("Devices of whatever nature for withdrawing profits or paying salaries to officers are not pension trusts within the meaning of the Act.") The Department of Treasury also proposed legislation that would have imposed not only nondiscrimination rules, but also minimum vesting requirements and contribution and benefit limitations (both added to the Code in 1974, as part of ERISA). As noted in the text, *infra*, Congress did enact the nondiscrimination rules as part of the Revenue Act of 1942.

[17] *See* Norman P. Stein, *Some Lessons from History: The Origins of Pension and Profit-Sharing Taxation, 1914-1942*, 58 N.Y.U. INST. FED. TAX, EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION Ch. 12 (2000); Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 433 (1987); Patricia E. Dilley, *The Evolution of Entitlement:*

each of these views. Indeed, some of the historical debate is not over which view is correct, but rather over which view predominated policy thought in 1942.[18] .

All three views continue to provide perspective for discussion of pension and tax policy, although I will suggest in this paper that today the third idea is understood more in terms of trying to effect broad pension coverage in the general population, especially of rank-and-file employees who are unlikely to save adequately for retirement on their own.

It is noteworthy that the Roosevelt Treasury Department had also proposed adding minimum vesting requirements as a condition of plan qualification. The Roosevelt proposal would also have put limits on the size of benefits that could be paid from qualified pension plans. Although Congress then rejected these ideas, they are consistent with the first view (controlling the tax sheltering aspects of qualified plans) and the second view (reserving the tax subsidy to socially beneficial plans). After the 1942 legislation, Congress did not enact substantial pension tax legislation for three decades, when the ideas of vesting standards and benefit limitations found statutory manifestation in ERISA.

The 1940s and 1950s was a time of significant growth of pension plans. The excess profits tax and generally high income tax rates, plus wage stabilization measures during World War II and the Korean War, encouraged firms to establish pension plans and labor to negotiate them.

Although it was unclear whether under the National Labor Relations Act unions could require management to negotiate over pension benefits, the United Mine Workers, lead by

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Retirement Income and the Problem of Integrating Private Pensions and Social Security, 30 LOYOLA L.A. L. REV. 1063 (1997).

18 *See Stein, supra* note 16, at § 12.03[3].

John L. Lewis, negotiated a pension and health plan for the coal miners in 1946. The plan was to be supported by the contributions of unionized coal companies but was to be administered exclusively by the UMW.

Business interests were alarmed by the possible consequences of a union's exclusive control over a pension fund and the substantial economic power such control would vest in the union. Reacting to these concerns, Congress just one year later enacted the Taft-Hartley Act, which required that management participate in the administration of any fund in which the union had an administrative role.

In 1948, the National Labor Relations Board settled the issue of whether pensions were a mandatory subject for bargaining, holding that they were. The NLRB's decision was judicially affirmed in 1949, clearing the way for the establishment of numerous negotiated pension plans over the next decade. The idea of investing plan assets in the broad economy, i.e., in corporate equities, also took hold at the start of the 1950s. Pension plan membership and pension assets increased geometrically during this period and continued to expand into the 1960s.

In the latter half of the 1950s governmental attention turned to perceived mismanagement of assets by plan trustees, particularly in jointly-managed Taft-Hartley plans. Congressional sentiment split over whether reform legislation should be limited to Taft-Hartley plans (in which case the legislation would have been seen as anti-labor) or applicable to the universe of private sector plans. Congress ultimately enacted broadly applicable disclosure legislation, the Welfare and Pension Plans Disclosure Act, but the business community tolerated broad coverage only with a compromise: the legislation required substantial reporting but its enforcement provisions were defanged. Michael Gordon, a principal participant in, and observer of, the process of pension reform legislation in the 1960s and 1970s, nevertheless viewed the legislation as significant by applying to all plans and viewing pension legislation as a labor (as opposed to tax) issue.

Concern about private sector retirement plans continued in the early 1960s. The Kennedy Administration established a cabinet level tax force charged with reviewing the "role and character of the private pension and other retirement systems in the economic security system of the Nation." The task force ultimately reported to President Johnson in 1965, but in the interim "the passage of the WPPDA in 1958 had unleashed a nonstop torrent of mail from employees all over the country complaining over their failure to qualify for private pension benefits." In addition, the Studebaker Corporation closed down its United States operations, leaving a substantially underfunded pension plan behind. As a result, thousands of employees with vested benefit rights received none or substantially reduced benefits. The failure of Studebaker's plans and the complaints about forfeited benefits were manifestations of problems that could be traced to the earliest pension plans.

An important development also occurred in the realm of tax theory: the Department of Treasury, with Stanley Surrey serving as Deputy Secretary for Tax Policy, advanced the idea of tax expenditure theory. This was not, of course, an entirely novel idea: it had been part of Treasury's argument for the nondiscrimination rules enacted as part of the Revenue Act of 1942. The President's task force, in its final report, recommended adoption of federal vesting and minimum funding standards, and also recommended limiting contributions to a defined contribution plan and benefits under a defined benefit plan to a maximum amount, on the theory that the government should not be supporting extravagant tax-subsidized pensions. In addition, the task force suggested that additional study be given to an insurance mechanism for defined benefit plans. Finally, the task force suggested creation of a voluntary portability system, in which pension credits could be transferred among plans.

Although the task force did not recommend adoption of comprehensive federal fiduciary standards for plan investments, a Senate hearing in 1965 revealed fraudulent investment practices among Taft Hartley plans, and fiduciary standards also moved onto the pension reform agenda.

Beginning in 1967, Congress began an annual legislative pilgrimage to the altar of pension reform, focusing on the problems of underfunded plan failure, of long-service employees never qualifying for benefits under restrictive vesting provisions, of mismanagement of pension assets, and of a perceived need to balance the encouragement of plans (through reasonable tax subsidization) and regulation of plan conduct to protect employees. This process ultimately culminated in the passage of the comprehensive pension reform legislation titled the Employee Retirement Income Security Act of 1974. ERISA amended the Internal Revenue Code, amending the Labor Code by repealing the WPPDA and adding new substantive and enforcement provisions, and creating the Pension Benefit Guaranty Corporation to ensure benefits in defined benefit plans.

Substantively, ERISA introduced seven major regulatory and tax changes to the federal regulation of pension plans:

(1) the imposition on pension plans of federal minimum vesting standards;

(2) the imposition on pension plans of federal minimum funding standards for defined benefit plans;

(3) the creation of a mandatory insurance program for benefits in defined benefit plans;

(4) the creation of federal fiduciary standards governing the conduct of plan administration and investment assets;

(5) the creation of maximum limitations on the amount of annual allocations to defined contribution plans and on the amount of annuity benefits payable from defined benefit plans;

(6) the creation of a system of limited portability, in which distributions from a pension plan could be transferred to either an individual retirement account or another retirement plan;

(7) a complex enforcement scheme in which the Department of Labor, participants, and plan fiduciaries were given access to federal courts.

In addition to what ERISA created in federal law, ERISA was also significant for what it took away from state law: ERISA included a broad preemption provision that superceded the laws of state and local governments to the extent that they relate to employee benefit plans. As will be discussed later in this paper, preemption bars pension plan participants remedies that were available under the laws of some states, leaving them only with federal remedies, which generally does not include a make-whole remedy for participants wrongfully deprived of their benefits under a plan.

The three decades between 1943 and 1974 thus saw three significant pension acts, although only the last of the three, ERISA, reflected a comprehensive approach to the various issues raised by private pension plans. Rather than signaling an end to a period of period in the history of federal regulation of pensions, ERISA ushered in an era of almost annual change in pension regulation. Some of this, of course, was predictable, as federal agencies developed regulatory interpretations of statutory language that was often general in its commands. What was perhaps not predictable was the pace of Congressional revision to the statute; beginning in 1978, just four years after ERISA was signed into law, Congress began a period (that has not yet stepped) of constant, almost annual, amendments to the statute.

Some of Congress's post-ERISA activity was technical, and some was in the nature of repair work. For example, the original rules for the PBGC invited some firms to terminate their underfunded defined benefit plans and shift the plan's liabilities to the PBGC at little cost to the firm. And ERISA's funding requirements, as originally written, were far too modest to ensure responsible funding of defined benefit plans. Other ERISA legislation expanded ERISA's vesting protections.

There are three types of post-ERISA legislative change that merit further discussion: those designed to help women; those designed to direct more of the benefits of tax-subsidized plans to moderate and lower income individuals; and those designed to limit the tax expenditure in periods of budget deficits.

The original version of ERISA addressed one issue of special concern to women, or at least to women who had been homemakers and thus were dependent on their husband's pension: the issue of survivor benefits. ERISA provided that the normal form of benefit for a married participant from a pension plan was a joint and survivor benefit; a participant could, however, elect another form of benefit if offered by the plan. Virtually all plans also offered single life annuities for the life of the worker. Because the joint and survivor annuity and the single life annuity needed only to have actuarial equivalency, and since the projected payout period for the single life annuity was shorter the monthly benefit was larger. Experience with the statute suggested that some men, without consulting their wives, chose the "larger" benefit. In addition, some pension plans did not provide any benefits of survivors of workers who died before reaching retirement age. Finally, profit-sharing plans, which do not have to offer annuity benefits, provided no statutory protections to spouses.

Congress, as part of the Retirement Equity Act of 1984, addressed concerns that women were being disenfranchised from their share of their husband's pensions. First, Congress created a right to a pre-retirement survivor benefit for spouses of vested participants. Second, Congress required spousal consent for a married participant to waive survivor annuities. Finally, Congress provided that in a profit-sharing plan the spouse has to be the beneficiary of the account if the participant dies, unless the spouse consents to the choice of another beneficiary.

As discussed earlier in this section, the prevailing understanding of the tax subsidy for qualified plans is that it is to provide retirement savings for employees who would not otherwise save adequately for retirement. The mechanism for creating such savings are the nondiscrimination rules. Congress, in the 1980s, enacted a series of provisions that were designed to improve the efficacy of these rules. In particular, Congress limited the degree to which plan benefits could be integrated with Social Security, a practice that at one time allowed plans to reduce benefits by more than 50% and sometimes even eliminate benefits for plan participants earning less than the Social Security wage base; created top-heavy rules that provided accelerated vesting rights and statutory minimum benefits to rank-and-file participants in plans weighted too heavily toward key business employees; imposed a salary cap on compensation that could be included in a plan's benefit formula, which resulted in increased benefits for employees whose compensation was less than the salary cap; imposed special participation requirements on plans of small businesses that covered fewer than 40% of the employees; and strengthened the rules intended to ensure reasonable levels of coverage of rank-and-file employees. As will be discussed in Section II, the nondiscrimination rules have undergone steady erosion during the last decade, and particularly in this year.

Finally, during the 1980s and 1990s, Congress made a number of changes to the rules that were designed, at least in part, as revenue raisers. For example, Congress twice reduced the limits on contributions to defined contribution plans and on benefits under defined benefit plans, the effect of which was to reduce the benefit levels for the most highly paid participants in qualified plans. Moreover, Congressional shoring up of the nondiscrimination rules is sometimes explained in terms of revenue raising: to the extent that firms have a fixed contribution level to qualified plans, shifting of benefits to participants with low marginal tax rates will reduce the tax expenditure. Similarly, to the extent that more effective nondiscrimination rules discourage plan sponsorship altogether, tax expenditures will be decreased. However, the estimated revenue gains from provisions designed to provide benefits for rank-and-file employees have been modest and probably should not be understood primarily as revenue driven.

A sometimes noted fact is that at the approximate time ERISA was enacted, pension coverage among members of the private sector nonagricultural workforce had plateaued, at approximately 50%. Since ERISA's enactment, that number has not changed appreciably.

II. The Problem of Leverage

Every year since 1974, the Joint Committee on Taxation has prepared a tax expenditure budget, an estimate of the year's lost tax revenue resulting from those provisions in the Internal Revenue Code that depart from the ordinary structure of an income tax. Among the provisions considered to produce tax expenditures are those that govern the tax treatment of "qualified" employer pension plans. The Joint Committee considers those provisions to generate tax expenditures: they defer taxation on what is effectively compensation income paid into a pension plan, and investment income earned on that compensation income. In the fiscal 2000 year, the Congressional Budget Office calculated the lost tax revenue related to public and private pensions at almost $100 billion dollars. This is a sizable sum; in fact, it will be the largest of all the expenditures in the 2001 tax expenditure budget.

Some have challenged the notion of a tax expenditure budget, although not necessarily the idea that certain tax provisions depart from the structure of an ideal income tax or create a tax subsidy for certain types of activities. And some have argued that the tax treatment of "qualified' pension plans does not involve tax expenditures or tax subsidies at all. But for purposes of this paper, I accept the conventional understanding that the Internal Revenue Code does provide a valuable tax subsidy for qualified pension plans, and that the subsidy should be justified by some purpose extrinsic to the goals of an income tax.

The orthodox explanation for the subsidy is the provision of retirement income security for employees who would not otherwise save adequately for retirement. The intended primary beneficiaries of the tax expenditure, then, are lower and moderate income employees, who often find it difficult to save on their own for retirement because of immediate consumption demands. More affluent individuals have greater capacity to save for their retirement on their own, without governmental assistance.

Given that the intended primary beneficiaries of the subsidy are low and moderate income workers, the structure of the Internal Revenue Code's subsidy of retirement plans might strike us as irrational, for its architecture is one of unreconstructed tax deferral for plan participants. The value of the tax deferral to a given taxpayer correlates directly to that taxpayer's marginal tax rate. Thus, the Code provides the greatest retirement tax subsidy to the people with the greatest capacity to save for their own retirement, and the smallest to those with the smallest capacity. But understood another way, this upside-down tax subsidy is an arguably rational component of a two-part governmental strategy to enlist the private sector in building retirement savings for lower and moderate income people..

This strategy is first, to make the tax benefits of qualified plans sufficiently attractive to the tax-sensitive people who own and manage businesses that they decide to set up plans to capture tax benefits for themselves; and second, to require such plans, once established, to provide meaningful benefits not only to the people who set them up but also to their moderate and lower income employees. The Code effects the latter part of the strategy through a series of statutory provisions, most prominently the nondiscrimination rules. Professor Dan Halperin has used a (tax) carrot and (regulatory) stick metaphor to describe the strategy. Some have labeled this simply trickle-down benefits policy, perhaps one more Washington monument renamed for President Ronald Reagan. This is the idea that I refer to here as leverage.

As the pension economist Alicia Munnell put it, "[t]he rationale for favorable tax treatment of qualified plans is that retirement benefits for rank-and-file employees will exist if Congress provides tax incentives that induce higher paid employees to support the establishment of employer-sponsored pension plans."

The qualified plan has been subject to criticism, and indeed, its rationale is only arguably rational. Firms do respond to the incentives by establishing plans. But firms often don't want to cover lower and moderate income employees because those employees, at least as a group, do not value deferred compensation at its cost to the firm. Accordingly, some employers who participate in the system play a game of statutory limbo, bending under the regulatory stick by manipulating the complexities of the nondiscrimination rules to minimize benefits for rank-and-file employees, while maximizing benefits for the highly compensated who will save even without governmental subsidization. Moreover, many employers simply do not respond to the incentives and fail to sponsor pension plans. Thus, the system is both overinclusive in that it provides benefits for those who can save for their own retirement without governmental incentive, and underinclusive because it fails to cover many low and moderate income workers and often pays such employees trivial benefits, if that.

Despite these criticisms, the basic paradigm--tax benefits to encourage plans, nondiscrimination rules to ensure that the plans provide meaningful benefits to regular employees--has endured as the rationale for the favored tax treatment of qualified plans. Qualified plan coverage of the private workforce has pretty much remained steady at around 50%.

There are, of course, different ways of measuring coverage, depending on how the workforce itself is defined. The coverage rate, for example, is only about 42% if all workers, regardless of age, are included. The rate increases to 50% if the relevant workforce excludes those under age 25, and increases further to 58% if it is limited to full-time workers over age 25. Not surprisingly, the coverage rates decline with income: the coverage rate for the top quintile by earnings approaches 75%, drops to approximately 70% for the second quintile, 60% for the third quintile, 40% for the fourth quintile and 20% for the lowest quintile.

There are two explanations for low coverage rates: employees working for firms that do not sponsor a plan and employees who do not participate in plans sponsored by their firms. There are three reasons for the latter explanation: (1) regulations that permit firms to exclude employees with certain characteristics (for example, part-time employees, employees covered by collective bargaining agreements, employees with less than a year of service, and employees younger than 21); (2) regulations that permit firms to develop additional criteria for plan coverage and (3) regulations permitting firms to establish plans--primarily 401(k) plans--under which employees must elect reduced current wages in order to participate.

Coverage statistics do not, of course, tell the entire story about private sector pension benefits flowing to moderate and lower-income workers, for they show only whether an employee, at any given moment, is currently participating in a plan. The Internal Revenue Code permits firms to sponsor plans that provide lower levels of benefits for moderate and lower-income workers. Moderate and lower income employees, as a group, defer a smaller percentage of their compensation to 401(k) plans than more affluent employees. Firms are permitted to include forfeiture provisions in their plans for employees who have not worked at least five years. Because average job tenures decline with income level, such forfeiture provisions will disproportionately affect moderate and low income workers.

According to one extrapolation of 1998 Social Security data, pension benefits provide 29.8% of the retirement income for the top quintile of income of the population above age 55; 28.1% for the second quintile; 16.1% for the third quintile; 6.8% of the fourth quintile; and 3.3% of the fifth quintile.

Thus, there are two issues that subvert the rationale for the tax subsidy of qualified plans: low and moderate income employees have low rates of coverage *and* they earn relatively low levels of benefits when they are covered. The two issues might be viewed collectively as one of effective coverage, i.e., coverage that results in meaningful levels of benefits for low and moderate income workers.

In the 1980s, Congress began a process of amending the Internal Revenue Code to improve effective coverage by adopting new regulatory measures designed to increase (2) coverage rates of plans when firms choose to sponsor them; and (2) the benefit accruals of lower and moderate income employees. To increase coverage rates in plans, Congress tightened the statutory rules that mandate a minimum degree of coverage and added a new provision to the Internal Revenue Code that required every plan to cover the lesser of 40% of the workforce or 50 employees. To increase benefits for rank-and-file employees, Congress limited the degree with which a plan's benefit formula could be integrated with social security; created a category of top-heavy plans, in which benefits were concentrated in the accounts of "key employees," that mandated accelerated vesting standards and minimum benefits for all other employees; accelerated the statutory vesting standards for plans generally; and imposed caps on the compensation that could be considered in benefit formulas.

I want to emphasize that Congress during this period did not provide incentives for employers to adopt new plans. Moreover, the addition of new stautory provision to improve effective coverage came during an era in which actual coverage rates dipped and it has been suggested that the coverage dip was in response to the cost of the new regulations. It has also been suggested that the coverage dip occurred because of the severe economic downturn in the mid 1980s. In any event, the coverage rates crept back to the 50% mark in the 1990s, possibly attributable to the strong economy we enjoyed during that decade.

It should also be said that it is difficult to assess whether the decline in coverage rates had a substantive negative aggregate effect on workers in the bottom two earnings quintiles, for we have no statistics on what I earlier referred to as the substantive coverage rate. We do not know, for example, how many of the people who lost coverage during the 1980's were actually accruing more than trivial benefits and we do not know whether they were vesting in the benefits they did accrue. The most sensitive firms to the costs of new regulatory measures, and thus most likely to drop their plans, would have been those whose plans provided little more than nominal coverage to their lower and moderate income employees. This suggests that the decline in coverage rates might have been due principally to firms dropping plans that failed to satisfy the purpose of the tax subsidy, at least as I have defined it for purposes of this paper.

If Congressional strategy during the 1980's was to tighten regulation to improve substantive coverage for the lower income quintiles, agency regulatory action sometimes moved in the opposite direction. The most striking instance occurred when Treasury issued regulations permitting firms to establish pure cash-or-deferred plans. These regulations interpreted the 1978 401(k) legislation, which was enacted to permit firms to offer employees to choose between a cash bonus or contribution to a profit-sharing plan, an issue whose resolution Congress had deferred in 1974 when it enacted ERISA. Despite the limited purpose of the 1978 legislation, the language of section 401(k) was drafted broadly and could be read to permit firms to permit employees to choose to defer regular compensation, not just end-of-the-year bonuses. Amid a high level of uncertainty about whether the legislation should be read this broadly, Treasury issued regulations that endorsed this position. Over the next two decades the 401(k) plan became the most popular form of plan. The participation rates in such plans are considerably lower for employees in the bottom income quintiles than for other employees than in traditional employer-funded plans..

Similarly, the Department of Treasury proposed in 1989, and finally promulgated in 1991, nondiscrimination regulations that tolerate if not encourage substantial disparities in benefit accruals between the highly compensated employee and the nonhighly compensated employee, particularly in smaller plans. At least with respect to plans of smaller firms, the regulations often permit the construction of plans that maximize benefits for the highly compensated while minimizing benefits for lower and moderate income workers. The so called cross-testing rules, which permit some firms to establish defined contribution plans in which the most highly compensated employees receive annual account allocations that are more than twenty times the allocations provided for lower-paid employees have been the most visible and controversial part of the regulations that enable firms to effect such goals.

It is difficult to assess the net effect of the legislative and regulatory modifications of the nondiscrimination rules during the 1980's, but my own sense is that these opposing forces probably left the overall substantive coverage rate for the lower two quintiles about where it was at the beginning of the 1980's, despite the Congressional agenda to improve benefits for lower and moderate income workers. Had the regulatory agenda been consistent with Congressional policy decisions it is possible that the level of substantive coverage would have increased even though the nominal coverage levels might have declined.

The Congressional climate changed dramatically in the 1990's. Congress shifted its focus from improving benefit adequacy for the moderate and lower income employee to broadening the opportunities for affluent plan participants to save on a tax-deferred basis and making plan sponsorship more attractive to firms that do not now sponsor plans. Increasing the amount that affluent participants can contribute to qualified plans does not, of course, directly effect benefit adequacy for low and moderate income employees, although it does come with a high tax-expenditure tax tag suggestive of Congressional priority. The approach that Congress has crafted to cajole new plan sponsorhip, however, will reduce benefit adequacy. The approach is one of reduced regulation.

Congressman Benjamin Cardin, an architect of this approach, wrote of a legislative package, now largely enacted, that he helped design,

> . . . H.R. 10 will help extend the opportunity for tax-favored retirement savings for workers in small businesses. To date, only a small proportion of small businesses have set up retirement savings plans for their workers.
>
> Among companies with fewer than 100 employees, 80% of the workforce has no pension or retirement plan. Compared to large companies, where 75% of the work force has a retirement plan, this demonstrates the urgent need to make it easier for small businesses to set up retirement savings plans. H.R. 10 will remove burdensome regulations that have made it difficult for small businesses to give their workers the opportunity to save for retirement.

Burdensome regulations make a convenient windmill for any brave legislative knight. Indeed, everyone can agree that regulations should be simplified when a regulatory burden is generated by complexity alone, i.e., when plan sponsors have to pay consultants to decipher the meaning of a regulation's requirement or to determine whether they are in compliance ("first, lets pay all the lawyers"). But the regulations that Congress has recently eliminated or softened did not impose a complexity burden of this variety. The burden they imposed was simply the financial cost of providing a nontrivial level of benefits for lower and moderate income employees.

Congress first loosened such regulations when it created safe-harbor 401(k) plans and the similar SIMPLE plan in 1996 legislation.[19] In traditional 401(k) plans employers must undergo an annual testing procedure designed to ensure that utilization of the plan by a firm's non-highly compensated employees bears a nontrivial relationship to the utilization by the highly compensated employees. The testing process, and correction process if the plan fails to satisfy the testing, do impose administrative burdens on the sponsoring firm, but a firm may design its plan and procedures to simplify these processes.

The 1996 legislation permitted employers to eschew the testing process if the plan design provides that the employer will make matching contribution for the employee equal to 100% of the first 3% of compensation that the employee voluntarily contributes to the plan, and 50% of the next 3% of compensation. For small employers, the same legislation created the SIMPLE, where the plan satisfies the nondiscrimination rules if it provides a match for only the first 1% of compensation. These types of plans are easier to administer than traditional 401(k) plans, but the result in many plans will be smaller benefits for moderate and low-income employees.

The rationale for these safe-harbor nondiscrimination requirements is that employees of all levels respond to employer matches in traditional 401(k) plans. But the matching requirements, which permit the employer to condition ultimate receipt of the match on three years of vesting service, were arbitrarily selected without empirical verification that the matches will be adequate to stimulate employee contributions, a concern with particular relevance to the SIMPLE plan where an employer can limit its match to the first 1% of salary contributed.

More problematic is that these plans alter firm incentives that might result in a less vigorous employee response to matches in these new plans than to matches in traditional 401(k) plans. In traditional 401(k) plans, firms have an interest in encouraging significant levels of plan participation in order to satisfy the nondiscrimination testing requirements. Firms sponsoring SIMPLE and safe-harbor 401(k) plans lack such incentive; indeed, the incentives run in the direction of discouraging plan participation, which would spare the firm the burden of making the matching contributions. There is thus reason to believe that the net effect may be plans that provide less saving for nonhighly compensated employee than do traditional 401(k) plans.

If the effect were only to induce some firms that do not have plans to adopt new plans, the overall effect on retirement savings for moderate income employees would of course be positive even if small. The issue then would be simply whether the additional coverage would be worth the tax cost of these new plans. But when Congress created these new types of plans, they also encouraged some firms with traditional 401(k) plans, and firms with employer-funded retirement plans, to consider substituting a SIMPLE or safe-harbor 401(k) plan for their existing plan. And when firms do this there is likely to be an actual decline in the retirement savings of their moderate income employees. Thus, for aggregate effect on moderate income employees to be positive, the number of such employees who save less when their firms replace an existing plan with a SIMPLE or safe-harbor 401(k) plan would have to be more than outbalanced by

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[19] Small Businss Job Protection Act of 1996, Pub. L. 104-188.

the number of employees who were not covered by any plan at all prior to their firms adopting a SIMPLE or safe-harbor 401(k).

There is reason to believe that negative effects--lost savings--predominate. First, most firms that do not sponsor plans say they lack sufficient business profit to justify adopting a plan. Firms where business profits are low, typically will not have any highly-compensated employees and are thus within an effective safe harbor--plans with no highly compensated employees automatically pass nondiscrimination testing. Thus, the SIMPLE and safe-harbor 401(k) plans add little to the mix of incentives for these firms. Second, the recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 increases the amounts that can be contributed to SIMPLEs and safe-harbor 401(k) plans, thus making them attractive to a wider range of firms already sponsoring plans; and also increases the deductibility limits for individual retirement plans to $5,000, providing some small business owners with an alternative to adoption of a qualified plan that must provide some benefits to their employees.

EGTRA included several provisions that allow firms to design their plans with lower levels of benefits for moderate and lower income employees than were permitted pre-EGTRA. Section 416 of the Internal Revenue Code, for example, mandates that "top-heavy" plans--plans in which "key employees" have accumulated 60% or more of the aggregate benefits under the plan--must provide accelerated vesting and a minimum benefit for each plan participant. For defined contribution plans, the minimum benefit is generally equal to 3% of a participant's compensation. In many 401(k) plans and so-called new comparability plans the minimum contribution is the sole reason most non-highly paid employees are accumulating even a marginally meaningful benefit. (In new comparability plans, however, key employees may be receiving benefits in excess of 20% of their compensation). EGTRA makes several definitional changes that will reduce the number of plans that must provide minimum benefits to non-key employees. It will also permit top heavy plans to credit employer matching contributions toward the minimum benefit requirement.

While critics of the top-heavy rules complain about the complexity of determining top-heavy status annually, this complexity can be entirely avoided if the plan provides 3-year vesting and minimum contributions equal to 3% of compensation. Thus, to a considerable extent, the complexity created by the top-heavy rules is voluntary on the part of plan sponsors. Moreover, the General Accounting Office was asked to study top-heavy plans and the resulting report found that few plans experienced substantial cost or difficulty in coping with the top-heavy rules. Congress, in passing EGTRA, ignored the GAO findings.it had. Because of the changes in the top-heavy rules, participants in many existing small plans will find their benefits reduced below 50%.

EGTRA weakened another Internal Revenue Code provision, the compensation cap, designed to increase benefits for all but the highest paid employees. The compensation cap limits the amount of compensation that can be considered in a plan's benefit formula. The effect of the compensation cap comes from an intersection between a plan's benefit formula and the dollar limits that Internal Revenue Code section 415 imposes on contributions and benefits. Before EGTRA, the statute set the compensation cap at $150,000, with adjustments for cost of living increases. In the year 2000, the inflation-adjusted index was $170,000.

In 2000, the maximum amount that a firm could contribute to a defined contribution plan was $30,000. Assume that a firm's owner had $200,000 compensation and that the firm's owner wants the maximum $30,000 contribution to his account. Also assume, for purposes of simplicity, that the IRC required the firm to contribute the same percentage of compensation for each plan participant.. Because the compensation cap forces the plan to treat the firm owner as if he were earning $170,000, the plan would have to use a 17.65% contribution rate for all participants in order to provide the owner $30,000.

EGTRA boosted the compensation cap to $200,000. Applying the new compensation cap to the above facts, the firm could reduce the contribution rate to 15% and still provide the owner with $30,000. The only effect of this would be to reduce by 15% the contributions made to the other plan particpants.

EGTRA made other changes that will permit or encourage some existing plans to reduce benefits for moderate and low income employees. Realistically, none of these changes is likely to result in substantial new plan sponsorship and to the extent they do encourage the formation of some new plans by lowering the amount of benefits that must be provided to low and moderate-income employees, those plans by definition will be providing lower levels of benefits to such employees than has previously been tolerated. Moreover, the probable dominant effect of these EGTRA changes will be the reduction of benefits for such employees in already-existing plans.

The only provision aimed directly at helping lower and moderate income workers is a government matching credit for certain lower income individuals who elect to contribute to an employer cash or deferral deferral plan or to an individual retirement account. The maximum credit is 50% of the amount contributed (up to $2,000), which applies to individuals with

$15,000 of less in adjusted gross income. The credit then drops top 20% for individuals with income over $15,000 but less than $16,250, and then drops to 10% up to $25,000 of income.

There are a number of reasons why the credit is not likely to contribute significantly to the retirement security of those at those to whom it is aimed. First, the credit is nonrefundable. The earned income tax credit and the child care credit, which reduces to zero the taxes paid by many families eligible for the credit, will mean that many taxpayers eligible for the credit will derive no benefit from it. Moreover, the $1,000 maximum credit nominally available under the statute is not actually available to any taxpayer: to be eligible for the 50% credit, the taxpayer can have no more than $15,000 in adjusted gross income, and the *maximum* possible tax liability for such a taxpayer is $855. And this will generally be lower because of dependency deductions and tax credits. Second, the income threshholds are not indexed to inflation, a stark departure from almost every other retirement plan limit in the Internal Revenue Code. Third, the credit declines to 20% once a taxpayer's adjusted gross income exceeds $15,000, and to 10% when income exceeds $16,250. It is questionable whether a credit of 10% or even 20% will be sufficient to motivate many low income workers to save for retirement. Fourth, the credit will only be available for five years. Finally, Congress designed the credit in apparent ignorance of the work of behavioral economists, whose research suggests that workers avoid savings programs in which their paycheck declines, which would be the effect if people make voluntary deferrals to an employer plan. And most people in the income range eligible for the credit will not have sufficient sums of money to make an end-of-the-year IRA deposit to qualify for the credit. And it is unrealistic to believe that potential recipients of the credit will make small weekly IRA deposits. The most likely effect of the credit will be to reduce slightly the taxes of low and moderate income people who are already saving in their employer's 401(k) plan. In my view, it is improbable that it will create significant new stores of retirement savings.

The legislative decisions reflected in recent pension legislation mark a retreat from the traditional carrot/stick blueprint for the tax treatment of qualified plans, which is to encourage plan sponsorship through tax incentives for the highly paid and force plans to provide the social benefit of retirement savings for lower paid employees through regulation. As Professor Bruce Wolk explained in 1982,

> . . . As the discrimination rules require more in the way of contributions for lower paid employees, the employer's costs increase. For any given employer, the costs may eventually exceed the benefits of covering the highly paid employees. At that point, the employer would decline to establish or continue a retirement plan. Thus, an aggressive congressional stance against discrimination might effectively preclude many lower paid employees from receiving retirement benefits. . . .
>
> Congress could avoid the adverse effect of aggressive discrimination rules by designing rules to ensure a high level of tax subsidy in relation to employer costs. Presumably this would result in a larger number of employers establishing or maintaining plans. Rules bringing about this result, however, would risk wasting the tax subsidy. To the extent that such rules would encourage employers to establish plans by excluding lower paid employees, the subsidy would be applied ineffectively. . .
>
> From Congress's perspective, the optimum level of tax subsidy is that which encourages the establishment of a retirement plan only if the social benefit of the plan equals or exceeds its costs.

Congress has moved in the direction of higher subsidies for the highly paid and lower regulation--sweetening the carrot and softening the stick. This will result, as Dan Halperin has noted, in more but worse plans. If the only result were the addition of new plans the problem would only be one of cost--are we getting enough social benefit given the tax costs of such new plans? But the result will also be the reduction of benefits for lower paid employees in existing plans.

Perhaps this suggests a paradigmatic shift in our understanding of the tax subsidy for qualified plans, away from the provision of retirement savings for middle and lower income workers who otherwise would be undersaved for retirement. Perhaps the emerging understanding of the tax subsidy for qualified plans is that it is simply to increase our overall national savings rate without regard to whether it helps moderate income people save for retirement. Another possible explanation for the qualified plan tax subsidy is that it introduces a consumption tax element to our tax system, which provides a partial balance to the bias of an income tax against savings. A third possibility, although one that by its nature cannot be explicitly acknowledged in political discourse, is that the qualified plan subsidy is designed to provide indirectly a reduction in the effective tax rates of relatively high income taxpayers. The explanation assumes that providing the reduction indirectly through qualified plans accords political cover to what could not be legislated directly. Finally, one might argue that the tax subsidy is intended to primarily to increase retirement savings for the upper half of the middle class. The plan participation rate for the upper income band of the middle class is high (approximately 80%), and it is reasonable to think that some if not much of the high utilization is the tax subsidy embedded in qualified retirement plan

I accept that the alternative explanations for the subsidy outlined above already play some role in the political sustainability of the qualified-plan subsidy. But one of the explanations--the idea that the subsidy simply provides a tax rate reduction--is seldom acknowledged, and for the past 40 years none of the alternative explanations have been nearly as important as what I've sometimes called the qualified-plan paradigm in shaping the intellectual and rhetorical landscape that provide the tax subsidy its public justificatory context. Indeed, so dominant is the qualified-plan paradigm that the the sponsors of the recent pension legislation argue that such proposals are consistent with this paradigm, even though they could more easily be justified under one or more of the other explanations.

And this is at the heart of an important concern: the debate over retirement security is distorted. By arguing that their pension "reforms" will expand coverage and enrichen benefits for moderate and lower-income workers and thus are consistent with the traditional qualified plan paradigm, Congressional champions of these close off serious consideration of other measures that might in fact expand coverage and enrichen retirement benefits for these workers. If they instead sought to justify their proposals on the basis of one of the other alternatives for the qualified plan subsidy, we might expect two positive political outcomes: explicit discussion of the merits and costs of their suggested justification (whatever they might be) and consideration of proposals to help lower and moderate income workers build retirement security apart from the universe of employer-sponsored plans. Inevitably, this latter consideration should include proposals to modify social security in this direction.

II. The Problems of Linkage

Certainty and understanding are virtues in a retirement program, whether the program is designed to provide an old age or disability pension, and whether the program provides income replacement or medical benefits. Participants who do not understand what they are promised, or who cannot rely with certainty on the promises made, may reach a time of dependency with inadequate resources, too late to make alternative arrangements. The relationship between understanding and certainty is what I refer to as linkage: the idea that the retirement promise understood by the employee is legally binding on the maker, that the promise and enforceability are linked.

The problems of linkage occur when participants believe they are being promised something different from what they have an enforceable contractual right to. Despite ERISA's goal of ensuring the certainty of the benefit promise, the problems of linkage have been a fixture of the retirement benefits landscape and are likely to remain a fixture. This section of the paper reviews the primary types of linkage problems that haunt participants in private pension plans.

Before considering those problems, however, I want to observe that increased linkage of the expected and enforceable retirement benefit promise comes with a price tag: it restricts employer flexibility, which in a voluntary system could result in fewer plans, lower benefits, or both. Thus, I approach the issue of imperfect linkage less as a critique of the current system than as a fact whose effects on employee retirement security should inform the social security debate.

A. The Reservation of Rights Clause and Retiree Health

Competently designed employee benefits plans generally include a waiver of rights clause under which the firm can modify or terminate a plan at any time. Such clauses sometimes begin with strong endorsements of the plan and then disavow any obligation to employees to continue to maintain the plan. For example, General Motors' retiree health plan included the following language:

> General Motors believes wholeheartedly in this Insurance Program for GM men and women, and expects to continue the Program indefinitely. However, GM reserves the

> right to modify, revoke, suspend, terminate, or change the Program, in whole or in part, at any time.

Arthur Conant, writing in 1933, referred to such clauses as weasel clauses.

Federal courts have generally held that such clauses are enforceable, despite employer conduct that suggests that the plan is permanent and cannot be modified or terminated. A Sixth Circuit case involving the General Motors clause quoted above is typical. General Motors distributed numerous plan descriptions over the years, some of which included reservation of rights language, but some did not. All of the plans descriptions emphasized how valuable the benefit was in early and prominent language and included the reservation of rights language at the end of the booklet, sometimes in small print. General Motors supervisors and human resources personnel made repeated oral and written representations that the retiree health benefits would always be available. A long history of uninterupted plan benefits, a corporate ethos and employee culture of which retiree benefits were an important part, all reinforced the employee belief that the rights were permanent. In 1987, more than a quarter century after the plan was adopted, General Motors modified the health care plan in ways that substantially increased retiree costs and decreased plan benefits.

Groups of retirees brought a civil action against General Motors, but the Sixth Circuit, partly reversing a district court decision in favor of a group of early retirees who had waived other rights for a package that they believed included retiree health benefits, held that the reservation of rights clause trumped all other representations and expectations because it was part of the written plan document:

> ERISA "has an elaborate scheme in place for beneficiaries to learn

> their rights and obligations at any time, a scheme that is built around reliance on the face of written plan documents." To implement this scheme, ERISA requires that every plan "shall be established and maintained pursuant to a written instrument." 29 U.S.C. § 1102(a)(1). ERISA also requires, as we have said, a written summary plan description that will "reasonably apprise . . . participants and beneficiaries of their rights and obligations under the plan." 29 U.S.C. § 1022(a).
>
> The writing requirement ensures that "every employee may, on examining the plan documents, determine exactly what his rights and obligations are under the plan." And the requirement lends predictability and certainty to employee benefit plans. This serves the interests of both employers and employees.
>
> "Congress intended that plan documents and SPDs exclusively govern an employer's obligations under ERISA plans. We recognize that "this may not be a foolproof informational scheme, although it is quite thorough. Either way, it is the scheme that Congress devised."
>
> Our court has consistently refused to recognize oral modifications to written plan documents. "We are quite certain," we have explained, "that Congress, in passing ERISA, did not intend that participants in employee benefit plans should be left to the uncertainties of oral communications in finding out precisely what rights they were given under their plan." Therefore, the "clear terms of a written employee benefit plan may not be modified or superseded by oral undertakings on the part of the employer."

The rarefied world conjured into being through judicial magic is not the world inhabited by most employees, who employers generally condition to accept representations made by supervisory personnel. The distinction between a provision in the written plan document and an oral representation or written representation made outside the plan document is not one with which a typical employee is likely to be familiar. Moreover, a substantial body of empirical research demonstrates that employees generally learn best through a combination of sources, including oral communication from supervisors. To privilege the formal plan document over other forms of communication contradicts basic behavioral rules governing the workplace.

Reservation-of-rights clauses, even when employees are aware of them and understand that a firm might exercise its rights thereunder, create problems of certainty for employees trying to plan for their retirement security. Where such clauses exist, employees cannot depend on employer-provided health benefit when they retire, and after they retire cannot depend on their continuation. A rational employee response would be to make other arrangements for health care before they retire, since once they retire their ability to engage other arrangements will be constrained by their then fixed financial resources. An employee who responds in this manner will probably attach little or no value to the employer's suggestion that it will provide its retirees with health care. In such an environment, a firm would probably not make such suggestions to its employees.

B. The Implicit Bargain in Defined Benefit Plans

In traditional defined benefit plans, benefits are backloaded, i.e., the benefit accrual increases geometrically in value as an employee ages. There are two reasons for this: first, the value of a dollar of promised retirement income is directly related to the length of the discounting period--the interval between benefit accrual and retirement. Thus, the older the employee, the shorter the discounting period and the greater the value of a dollar's worth of benefit. In addition, most defined benefit plans are based on a formula incorporating the employee's final pay--1% of final pay times years of service, for example. Thus, an increase in compensation for one year increases the value not only of that particular year's nominal benefit accrual, but also of the nominal benefit accruals of all prior years.

Under a traditional defined benefit plan, then, the bulk of a long-service employee's benefits are "earned" in the last years of the employee's service. Indeed, an employee who spends most of his working life with a single firm will earn more than half of a final-pay defined benefit during the last ten years of employment. The implicit bargain reflected in a traditional defined benefit plan then is that the firm values loyalty and long service and will reward such service in the last years of service with substantial defined benefit accruals.

The firm, however, has the legal right to terminate a defined benefit plan or modify its benefit formula. The financial rewards to the employer who does so can be substantial. While an employee's accrued benefit at the time of a termination or modification is protected, the employee is deprived of the implicit bargain she had been offered, i.e., that most of her benefit would be earned during the last period of employment. The loss to an employee in middle age can be substantial.

C. Other Defined Benefit Plan Issues

There are two other significant linkage problems in defined benefit plans. One involves the subsidized early retirement benefit inlcuded in some plans for people who retire after a certain age and/or after a specified number of years of service. An employer can amend the plan, however, to eliminate or reduce such subsidies for most employees. For example, a plan might provide that an employee with 30 years of service can retire at age 60. An employee who is age 55 with 25 years of service begins planning to retire at 60, but in the interim the employer amends the plan to eliminate the benefit. While the employee can still retire at age 60 with the benefit calculated based on his service and salary at age 55, the firm has made the employee's age-60 retirement problematic.

The other significant defined benefit plan linkage issue concerns underfunded plans. A defined benefit plan's ability to meet its benefit commitments depends on its level of funding and the success with which its assets are invested. A defined benefit plan can fail; in cases of failure the federally chartered and regulated Pension Benefit Guaranty Corporation takes over the plan and pays participants guaranteed benefits. The benefit guarantees, however, can be far less than the employee's vested accrued benefits.

D. Standard of Judicial Review of Benefit Denials

The Supreme Court, in 1989, resolved a question that divided the circuits: whether a court reviewing a benefit denial should accord deference to the plan administrator's factual findings and plan interpretations. The Court held that judges should defer to a plan administrator if the plan's language vested the plan administrator with discretionary authority to decide benefit claims. This approach to judicial review of benefit denials creates linkage issues, for a participant is not entitled to a court's interpretation of a plan's provisions, but only the court's determination of whether the plan administrator's interpretation of the plan is arbitrary.

This has been particularly problematic when there are disputed factual issues, such as whether a participant is totally disabled. In such cases, courts focus not on whether the participant is totally disabled, but rather on whether the plan administrator behaved arbitrarily in determining that the participant was not totally disabled. In numerous cases, courts have ruled that a plan did not behave arbitrarily in denying disability benefits to a participant who has been found totally disabled by the Social Security Admiinistration.

E. Obscure Plan Provisions

Employee benefit plans sometimes include provisions that are not understood by plan participants and have the effect of reducing the benefits to which employees believed they were entitled. I offer two examples from a pension counseling clinic at the University of Alabama.

In one of the cases, a plan provided a retirement benefit, but included a benefit offset for worker's compensation benefits. The summary plan description included one sentence mentioning the offset in its 40 pages, but did not describe how it worked. The union that had negotiated a series of collective bargaining agreements with the employer was unaware of the provision, as were the management personnel at the division where the plan participant worked.. The participant experienced a work-related injury, filed for worker's compensation and ultimately settled his claim for a lump sum payment of $50,000, 20 percent of which went to his lawyer. The offset formula in the plan reduced his monthly pension to zero. The participant was unaware that his settlement would have any effect on his pension.

In the second case, a large national employer sponsored a defined benefit plan. The plan's benefit formula is a multiple of years of service and the average compensation during the high consecutive five years of pay during the most recent ten years of employment. A participant in the plan took part-time status, reducing her pay by approximately 50%. At the time she took part-time status her accrued retirement benefit, a monthly annuity that began at age 65, was approximately $800 per month. In her sixth year of part-time status, her accrued benefit began to drop in value as the ten-year reference period began dropping off her full-time compensation years. Her benefit ultimately declined in value to approximately $500 per month, despite her additional years of service for the firm. If she had quit, rather than taken part-time status, her benefit would be worth almost twice its current value. She was unaware that her decision to work part-time could reduce her already-accrued pension benefits, although she might have been able to determine this if she had had a pension consultant review the plan document before she took part-time status.

F. Some Thoughts About Linkage and Defined Contribution Plans

In the past two decades, defined contribution plans have replaced defined benefit plans as the most common form of retirement vehicle. Defined contribution plans generally do not create linkage problems: the employee receives exactly what is in his or her account and there is no difference between what the employee expects to receive from the plan and in fact does receive from the plan. But the deeper structural issue in linkage is not the disparity between what employees believe they have been promised and what they actually have been promised, but rather the gap between what the employee perceives to be the value of his or her benefits and the actual value of those benefits. From this perspective, defined contribution plans pose an issue similar to leakage, since studies strongly suggest a tendency for employees to overvalue the benefits they will receive from defined contribution plans.

There are two ways in which employees apparently overvalue defined contribution accounts: first, many employees overestimate the rate of return they are likely to achieve on their accounts. Second, employees tend to overestimate the amount of retirement income their account will provide once they retire. These effects, to a certain extent, can be countered through educational efforts.

IV. Leakage

Retirement plans are designed to provide a continuing source of income for people after they leave the labor market. In an ideal world, free of inflation, the plan would provide its participants a periodic and steady annuity until they die. In the case of married participants, the plan would provide a periodic and steady annuity until the later of the death of the participant and spouse, with perhaps an appropriate downward adjustment on the first death. Each year, however, retirement plans pay billions of dollars of benefits that are not so applied: they are either spent before retirement or exhausted too quickly in retirement.

The most cited form of leakage is the lump sum payment of pension benefits when a participant leaves employment or takes an in-service distribution from a 401(k) or other profit-sharing plan.. Plans are permitted to pay participants cash when they leave if the benefit has a present value of under $7,500 or if the employee consents. Statistics derived from the 1993 Current Population Survey indicate that 20% of the population who received lump sums rolled over the entire amount into an IRA or other qualified plan; that 40% rolled over part of their distribution; and 40% did not roll over any part of their distribution. In sum, participants rolled over approximately 2/3s of the total value of the distributions. A survey of its 1996 data base by Hewitt Company indicated that 40% of participants rolled over their distributions, representing 79% of the total distributed assets. It should also be noted that not all of the money rolled over into individual retirement accounts will stay there, for amounts in such accounts are easily accessible to the IRA owner.

The two studies noted above suggest that older participants, and participants with large distributions (two groups with considerable overlap), are the most likely participant groups to roll over their distributions. This should not, however, be a source of comfort: for purposes of thinking about leakage from a retirement system, it makes more sense to project the future dollar of a distribution to the retirement age of the distributee. The following chart shows the amount of lost benefits at age 65 for a $5,000 distribution using six, eight, and ten percent interest assumptions for a 20 year old, a 30 year old, a 40 year old, a 50 year old, and a 60 year old.

Age	6%	8%	10%
20	68823.05	159602.2	364452.4
30	38430.43	73926.72	140512.2
40	21459.35	34242.38	54173.53
50	11982.79	15860.85	20886.24
60	6691.128	7346.64	8052.55

Using the mid-range assumption, the 30-year old's failure to preserve ar $5,000 distribution causes a loss of almost $75,000 of retirement benefits.

Congress has attempted to control leakage, in part, through the assesment of a 10% excise tax on premature plan distributions unless rolled over. A distribution is generally considered premature if it is made to a participant prior to the year in which the participant attains age 59.5. Over the last fifteen years, however, Congress has carved out exceptions to the penalty tax for plan and IRA withdrawals to pay for college tuition, to pay health care expenses, or to help pay the downpayment on a first home.

Similarly, Congress limits in-service withdrawals from 401(k) plans except in cases of hardship. Hardship withdrawals can be made in circumstances similar to those that result in a waiver of the 10% excise tax, i.e., to pay medical expenses, to pay tuition, to purchase a first home, and other hardships, which might, for example, be the purchase of a car.

One can argue that pre-retirement leakage is not necessarily a bad thing. Purchasing a home can be an important investment for retirement, as can reducing high interest debt. If the home purchase or debt reduction would not have otherwise taken place, perhaps permitting access for such purposes is defensible policy. Moreover, allowing access to retirement savings to pay for a child's education can be defended on general policy grounds and to the extent it will enhance the child's lifetime earnings and thus put the child in a better financial position, might even be supported as indirectly contributing to the parent's old age security.

It has also been argued that employees would be less likely to make elective deferrals to 401(k) plans if they could not access their accounts in times of financial stress. Thus, in a voluntary retirement system in which employee willingness to participate is necessary to the system's viability, fashioning a policy compromise between locking up benefits until retirement and encouraging employee voluntary participation by permitting pre-retirement access to their benefits in certain circumstances.

Discussion of leakage is generally confined to participant access to retirement plan assets prior to reaching retirement age. But if the purpose of qualified retirement plans is to ensure adequate income in retirement, premature exhaustion of benefits, i.e., before death, or failure to exhaust assets in retirement, i.e., by death, are also forms of leakage. The former is a source of leakage if we conceptualize the idea of retirement security as a method of providing a sufficient and generally steady stream of income after an individual permanently leaves the labor force because of age or disability. Frontloading consumption by drawing down financial resources early in retirement is inconsistent with this goal and thus can be characterized as a form of leakage. Moreover, in an economy in which some level of inflation is a permanent feature, and in a world in which expenses, particularly medical expenses, increase with age, some degree of backloading of retirement benefits may be necessary to maintain a stable standard of living.

Dying without exhausting retirement resources and leaving the excess assets to nondependent heirs may also be understood as a form of leakage from a system designed to provide retirement income.

One can take issue with these broader conceptions of the idea of retirement leakage. In particular, such a description of leakage suggests the appropriateness of placing limits on personal autonomy and choice. If such limits are justified it is because our private-sector retirement system is tax-subsidized and has as its public purpose the provision of retirement income. Accepting such limits, however, suggests that post-retirement leakage can be eliminated only through mandatory, inflation-indexed annuitization of retirement benefits for the lifetime of an individual and in most cases the individual's spouse or domestic partner.

Recent pension legislation and trends suggest that some of the problems of post-retirement leakage are worsening and will continue to worsen. The last two decades have seen a shift from defined benefit plans, where annuitization is common, to a defined contribution world in which it is not. Moreover, the creation of cash-balance and similar types of defined benefit plans, which state benefits in the form of a notional account balance rather than a life annuity, have increases the likelihood of a cash-out on separation of service and decreass the likelihood of annuitization on retirement.

The Economic Growth and Tax Relief Reconciliation Act of 2001 included provisions that will exacerbate leakage problems. First, the Act greatly increased the attractiveness of profit-sharing plans over money-purchase plans, making it likely that many firms will abandon the latter plan form. Money purchase plans, however, include an important anti-leakage feature: a married participant generally must obtain spousal consent before taking a benefit distribution in any form but a qualified joint-and-survivor annuity. Spousal consent to a lump sum payment is not required in a profit-sharing plan.

EGTRA also increased the attractiveness of section 401(k) plans over other forms of qualified plan forms. I suspect, although am not aware of any empirical research verifying this suspicion, that participants have a greater sense of immediate ownership of accounts to which they voluntarily contribute than they do in benefits provided by an employer-provided plan. A stronger sense of ownership will often carry with it a stronger aversion to government control over access to retirement savings for non-retirement usage. That most section 401(k) plans include provisions permitting hardship withdrawals provides some indirect evidence for this view.

There is also some encouraging news about leakage. First, pre-retirement leakage may be reduced as educational efforts stress the value of saving for retirement in tax deferred vehicles. Second, EGTRA did include some provisions that make it mildly easier to roll over assets between different forms of tax-qualified plans, although roll overs have long been permitted to individual retirement accounts and annuity contracts.

Overall, however, the problems of leakage are difficult ones for our private pension system.. Moreover, it is difficult to envision a strong and politically viable natural constituency for legislative adoption of meaningful controls on leakage from the private pension system.

V. Social Security Privatization

The problems of leverage, linkage and leakage in private sector retirement plans have implications for the debate over whether to privatize social security and if so how. All three problems caution against replacing, fully or partly, the current defined benefit structure with a system of personal IRA-style accounts.

A. Loss of Leverage in the Private Pension System.

Social Security, for many Americans, is currently the sole source of retirement income, which relegates them to living below the poverty line in old age. Social security privatization is unlikely to improve the situation of the aged poor, who this paper suggests are likely to receive even less as a class from private sector retirement plans in the future than they have in the past.

Opponents of privatization have noted that the poor, on average, are less likely to understand investment management and are more likely to be victims of fraud or sharp sales practices. Their accounts will be smaller, which may, depending on how privatization is effected, result in higher fees and access to fewer investment alternatives. Low and moderate income earners will have less ability to monitor their employer's timely transmittal of funds to their designated private investment accounts, or their investment manager's recordkeeping and investment performance. They will also have fewer resources to address the inevitable problems that will arise in these areas. Moreover, any tax deferral inherent in privatized investment accounts will work to the relative advantage of higher income workers, whose social security accounts would receive a larger tax subsidy than workers who pay tax at low marginal tax rates. There are thus reasons to suspect that the benefit structure under a privatized account system will be regressive in practice.

Some proponents of privatization concede that this issue is genuine but that it can be mitigated by preserving an adequate minimum benefit. But preserving an adequate minimum benefit for the poor may face political obstacles, since the larger the minimum benefit the smaller the size of guaranteed benefits for other beneficiaries. Perhaps more troubling, proponents of privatization have suggested paying for privatization with benefit decreases. Two of these decreases would affect the elderly poor, even if the current minimum benefit were preserved. (I note that the benefit adjustments I criticize here are also advocated by some who argue against privatization of social security.)

The first suggested decrease is an adjustment to the Social Security indexation formula, which is thought to overstate the effects of inflation on the elderly by between .5 and 1.5%. The effect of this overstatement, however, is a slight upward adjustment in the real value of a social security benefit as the pensioner ages. Such an upward adjustment in real value is desirable for the elderly poor, since they start their retirement below the poverty level. Moreover, as people age their level of dependency, and consequently their cost of living, generally increases in real terms. Changing the indexation formula should be regarded as an undesirable benefit cut for the elderly poor.

The second suggested decrease would raise the social security normal retirement age. Ironically, one of the arguments for social security privatization is that the progressive benefit structure is illusory since the poor have, on average, shorter life expectancies than middle and upper income individuals. Raising social security retirement age, then, might have a disproportionate impact on the overall benefits paid to the elderly poor. Of more concern, however, is the reality that the elderly poor are likely to have had more physically taxing jobs and lives than average and early retirement for them may often result from necessity rather than choice. For those poor, increasing the normal retirement age will result in a reduction of monthly income support.

In 1987 Professor Michael Graetz argued that our polity should conceptualize a coherent and unified retirement policy, which begins with the recognition that social security provides inadequate benefits for all income classes and that the private pension system is heavily weighted to the wealthy. At the time that Professor Graetz was writing, he observed that Congress in 1986 was "willing to go quite far in an effort to ensure some distribution of benefits to low- and moderate-income earners." This paper suggests that agency-initiated regulatory changes have pushed in the opposite direction and that in the last decade Congress itself has reversed direction, increasing benefits for the affluent and reducing regulatory requirements designed to ensure a meaningful level of benefit distribution to others.

At the start of a new century, we still compartmentalize our retirement policy by separate consideration of the private and public retirement systems. As a result, our President and Congress see Social Security as a system in financial crisis, perhaps requiring radical surgery--private investment accounts financed through cuts in the guaranteed benefit--that will reduce the flow of retirement income to the most needy elderly; at the same time, Congress enacted and the President signed legislation that commits tens of billions of new dollars of tax subsidy into a system that primarily finances retirement benefits for America's most affluent citizens If we viewed the private and public systems as components of a single retirement policy, and if we understood that the ideal of using leverage to ensure some benefit distribution toward low- and moderate-income workers in private sector retirement plans has never worked well and is in the process of being abandoned, social security reform might be focused on improving benefits for those who will not benefit from the publicly supported private-sector pension system and not merely shoring up its finances.

B. Failures of Linkage

This paper's idea of linkage, that an employee's expectations about private sector benefits be linked to the ultimate realization of those benefits, is critical to the employee's ability to formulate reliable financial plans for retirement. Yet the private sector retirement system is one in which employee expectations and reality often lack linkage. Moreover, because private system depends on voluntary employer participation and employer flexibility, the problems of insufficient have no easy solution short of fundamental redesign of the system. An intermediate solution might be requiring more candid disclosure about employer retained rights to alter benefit programs and how that might affect employees. If this were done, however, the degree of certainty in the system might be altered rather than increased, since rationally acting employees would have to assume that their benefits would be modified to their detriment at a point when it was too late to make alternative arrangements. Ultimate payment of benefits would then become a windfall to employees who have made alternate arrangements.

The paper has also proposed that the shift to an increasingly defined contribution world has created further problems of uncertainty, in which the ability of employees to accurately assess their income in retirement--which depends on assumptions about future rates of return, life expectancy, interest rates (or annuity purchase rates)--is compromised, at least compared to the world of defined contribution plans.

The social security system, which historically has provided a strong measure of certainty, provides a counterweight to the instability of employee expectations in the private pension system. Converting the system to one of private accounts will necessarily undermine that certainty. Moreover, if the system does not require mandatory annuitization of benefits, a measure of uncertainty will continue through a person's retirement.

C. Leakage

The purpose of a retirement system is to provide income after someone leaves the labor market because of age or disability. Leakage occurs when assets of that system are applied to other purposes. Leakage is generally discussed in the context of preretirement distributions, particularly when an employee separates from service with an employer and receives a benefit distribution. This paper, however, defines the problems of leakage more broadly, to extend to disproportionate consumption of retirement savings early in retirement and a failure to consume fully such assets by death. I have also suggested that generally speaking, the period of retirement should extend to the second death for a married couple.

In the private pension system, the problem of pre-retirement leakage will continue, although it may be somewhat abated by educational efforts about the importance of preserving savings for retirement and the increased proclivity toward retirement savings of an aging workforce. Moreover, the design trend toward cash balance defined benefit plans and defined contribution and particularly 401(k) plans, where a sense of immediate ownership and access is fostered by the concept of voluntary salary deferral, and recent legislative changes that will encourage some firms to abandon their money purchase pension plans, will create additional leakage pressures on the system.

The increasing prevalence of cash balance and defined contribution plans will also contribute to other leakage issues, particularly the failure to annuitize. And indexation of benefits in defined benefit plans, which commonly took place on an ad hoc basis through the mid-1980s, is now a rarity.

Social security is a largely leak-proof system, with little opportunity for pre-retirement leakage and mandatory annuitized benefits on retirement. Moreover, social security provides mandatory spousal benefits and all benefits are indexed to the cost of living. In contrast to private pensions, social security benefits must be used for retirement purposes only.

The introduction of private accounts into the social security system could in theory be designed without creating leakage issues. Such a system would not permit pre-retirement access and would require the participant to purchase an inflation-protected annuity benefit with spousal protections. This is not, however, the probable design for a privatized system. Most, but not all, privatization advocates eschew the concept of mandatory annuitization. Moreover, there would be practical problems if private insurers were used to underwrite the annuity contracts, as has been proposed by some: annuitization of small accounts would be costly, insurance companies are not likely to want to issue indexed annuities, and participants would be at risk of insurer insolvency, which would be used as an argument against privatization.

If a private account regime were implemented with safeguards against leakage, political pressures might ultimately push the system to a different design. In the private system, in-service withdrawals from 401(k) plans are permitted in some circumstances and the excise tax on pre-retirement withdrawals from plans and individual retirement accounts are relaxed when withdrawals are made for certain approved purposes. The pressures that produced these leaks in the private pension system may well result in similar leaks from a privatized social security system, where people have accounts to which they contribute and thus may have a sense that they should be able to access that money, at least in emergencies.

Similar pressures would push for modification of any initial rule requiring annuitization. Moreover, societal and political sympathy might be particularly high in cases where people have strong need for access to their accounts: sicknesss, purchasing a home, etc. Any carveout for special purposes would impose an administrative cost on the system to determine eligibility for an exception.

In addition, the design of a mandatory annuitization--whether structured around the private insurance market, a governmental insurance provider, or some combination--may lead to participant dissatisfaction and consequent political pressure to drop required annuitization. If the structure for providing annuities is based exclusively on the private insurance market, annuities will likely vary dramatically depending on interest rates at the time of annuitization. Pensioners who are disadvantaged by this and who see similarly situated individuals receiving larger annuities are likely to feel cheated by the system. Insurance companies issuing annuities have much higher administrative costs than the social security system, which will be a drag on benefits. Even if a captive market results in a lowering of annuity load factors among private insurers, the necessity of having two systems will impose additional costs, lowering benefits. It is also possible that insurers will not want to annuitize small account balances, leading to political pressure to limit annuitization options for such individuals. If the government moved in as insurer of last resort for those with small account balances, the annuitization factors may be different, and less favorable, for those with the low accounts.

A purely governmental annuitization program might also engender political pressures to opt out of the system. If the government had to annuitize with a single conversion rate, individuals with large account balances, long life expectancies, and consumer savvy might argue that they should be permitted to use a private insurer if they can secure more favorable annuitization rates. Such pressure might lead to insurers underwriting the best risks, increasing costs for the governmental program. Participants left in the governmental program, faced with higher annuitization rates, might argue that they should be permitted to opt out of annuitization. Similar results might be expected if the system were initially designed with governmental and private components.

There is, then, a not insubstantial risk that even if the system were initially designed to require annuitization, that the concept of mandatory annuitization may erode over time.

Governmental participation in an annuitization program would also create possible public finance issues: if interest rates fall, the government--unless it purchased secure long term debt instruments, which might include purchasing such instruments from itself--would assume an insurance risk that might ultimately have to be financed out of public revenues. If interest rates rise and the system shows a surplus, there may be pressure from participants to provide upward adjustments to benefits and from other political actors to allow government to dip into the "surplus" for other programs.

Thus, developing a program of private accounts within the social security system carries with it the possibility of introducing leakage into the social security retirement program.