



Portable Pensions: The Inevitable Reform

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American Shareholders Association

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Portable Pensions

"Our people just value their ability to make their own personal decisions," Jerry Shea, chief policy advisor to union president John Sweeney, told the Los Angeles Times.

"They trust their own investment decisions more than they do anybody else's."

Wall Street Journal, April 24, 2002

Improving Retirement Security

- Retirement security should be focused on boosting all three legs of a person's retirement, *individual savings, Social Security, and pensions*, in the most efficient manner.
- Only by boosting savings in all three factors can we have real financial security for all working Americans give the new demographic and economic realities.

Portable Pensions

Pension Reforms and the 4 Legged Stool

1. Social Security
2. Private and Public Pensions
3. Individual Savings (IRA's, LSA's)
4. Other Areas (Health Savings Accounts, Unemployment Insurance Accounts)

Portable Pensions

4 Changes Putting Pressure on DB Plans

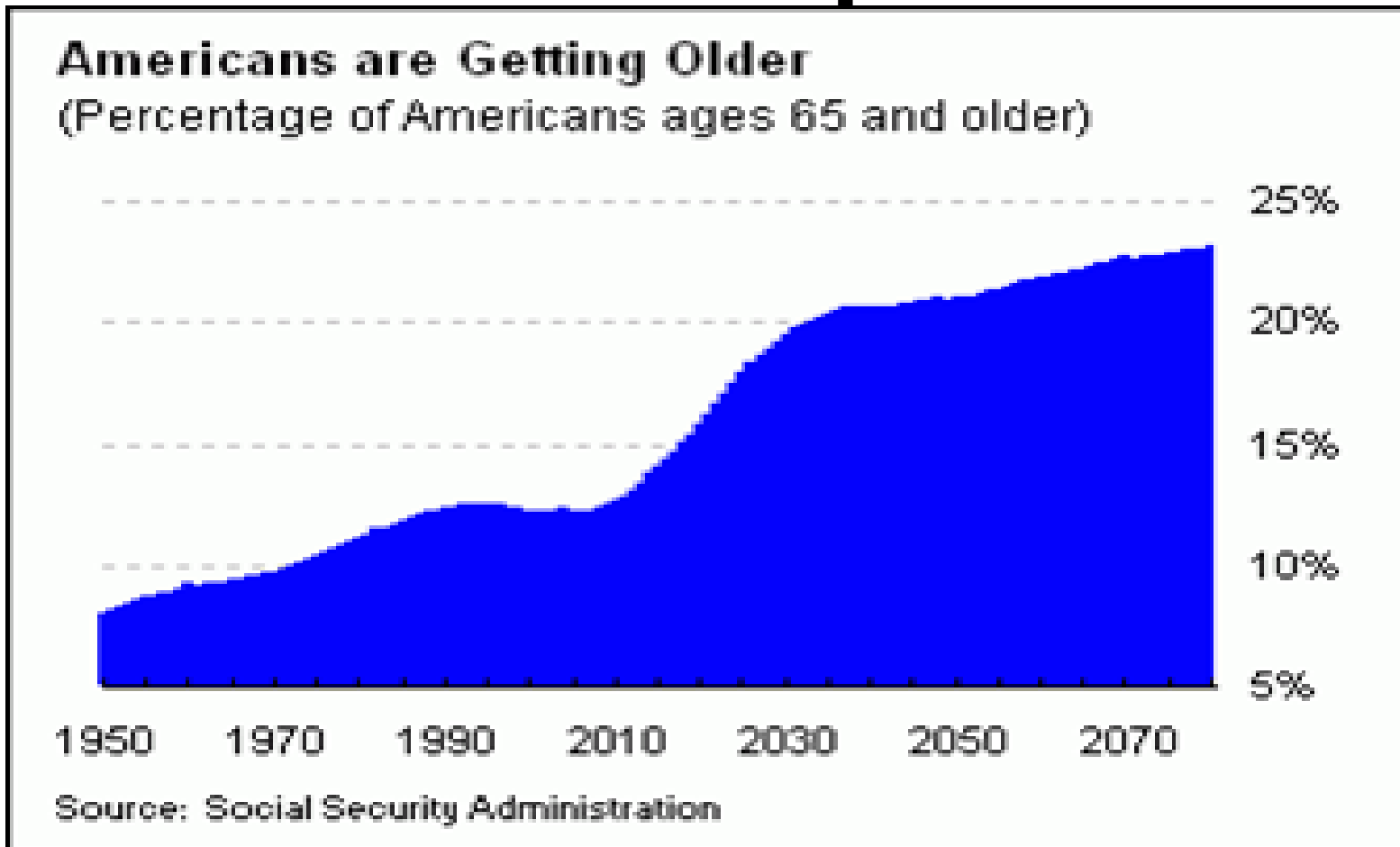
- Demographic
- Economic
- Labor Mobility
- Growth of Investors

Reason to Celebrate: People Are Living Longer

Longer Life Expectancies

- Longer Living Requires More DB Payments
- 100 years ago: 51.5 years for males and 58.3 for females.
- Today: 80 years for males and females' slightly more than 84 years.
- 65 and over population: 8 percent in 1950 to 12 percent today to 20 percent in 2035

The Aging of America's Population



Demographic Changes

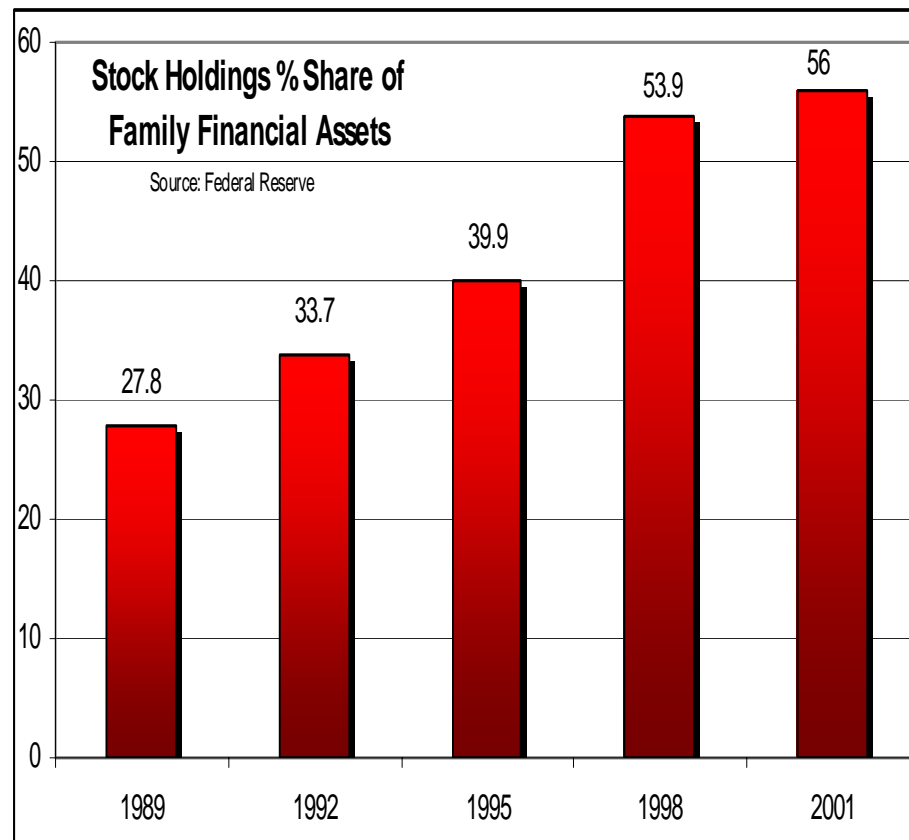
Baby Boomers

Retirement Tidal Wave Occurring

- Worker to Retiree Ratio Significantly Declining; Very Difficult for PAYGO
- Unfunded Pensions Will Have Hard Time Replacing Workers on a 1 to 1 Basis
- Places Upward Pressure on Contributions
- Requires Higher Rate of Return

Economic Readjustments

- Rapidly growing self employed sector
- Increased labor mobility
- Growing number of investors
- Requires greater portability



Public Policy Questions?

- As a result of these changing demographic and economic forces are leading to an evaluation of the nation's existing retirement, healthcare, and labor institutions.
- First, can entities maintain their financial standing without major tax increases/standard of living declines as the nation's demographics and economics shift?
- Second, how can public policy remove the impediment to savings to ensure financial security of America's workforce?
- Third, how can public policy create more flexibility and portability in response to the changing labor market?

SOCIAL SECURITY

The Challenge

Challenge for Policymakers:

- Continue with Social Security as a vital source of retirement income without looming tax increases and benefit cuts.
- The only way to do this is to move Social Security from a pay as you go to a fully pre-funded system, with personal retirement accounts.

Personal Retirement Accounts

- Fixes Both Problems of Social Security
 1. Eliminates unfunded liabilities in the current system
 2. Increases retirement income for younger Americans, relative to the current system.

Personal Retirement Accounts

- Workers are free to choose to stay in the old Social Security framework or have their own PRA.
- PRAs will open up investing opportunities to millions of Americans to ensure financial retirement security, individual empowerment, and asset ownership.
- Because of the much higher returns produced by productive market capital, workers in the new, personal account system will enjoy much higher benefits than promised by Social Security today.

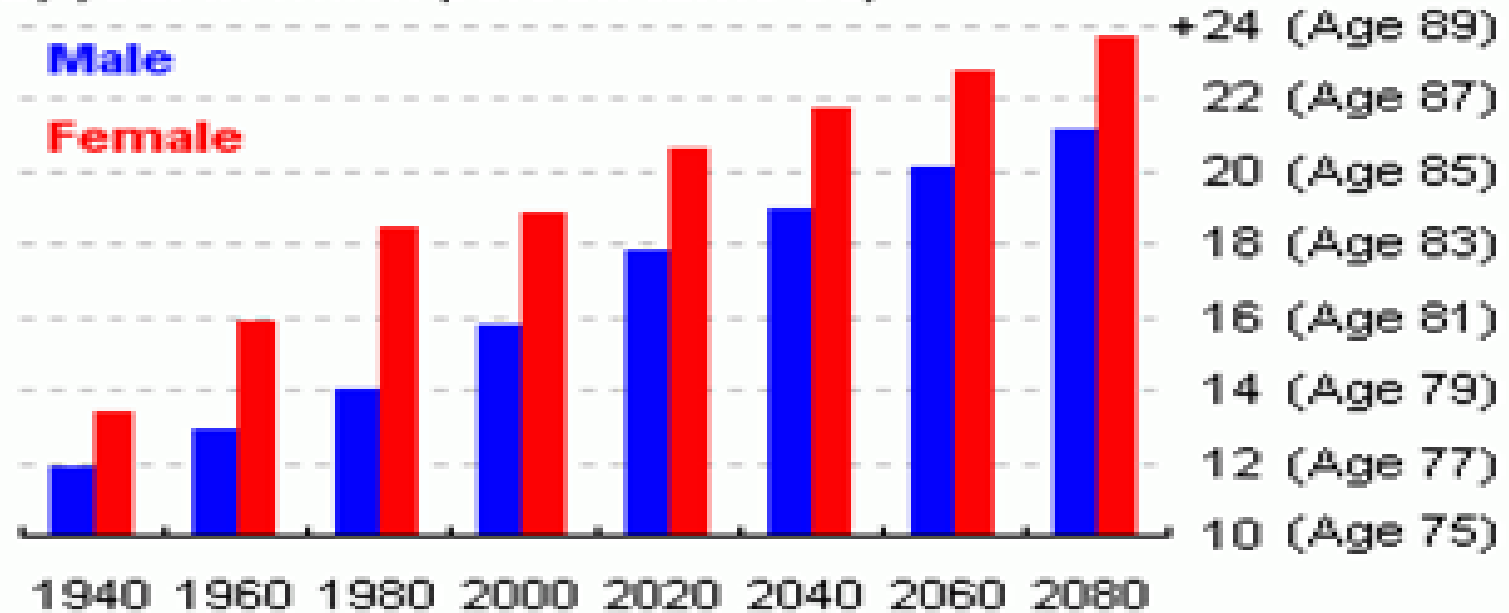
Personal Retirement Accounts

- The higher rate of return will offset any negative effects of the guaranteed benefits
- As a result, Social Security can be solvent and workers have greater control without tax increases/ reductions in their standard of living

Seniors Are Living Longer

Seniors are Living Longer

(Additional life expectancy for those who reach age 65, by year in which person turns 65)

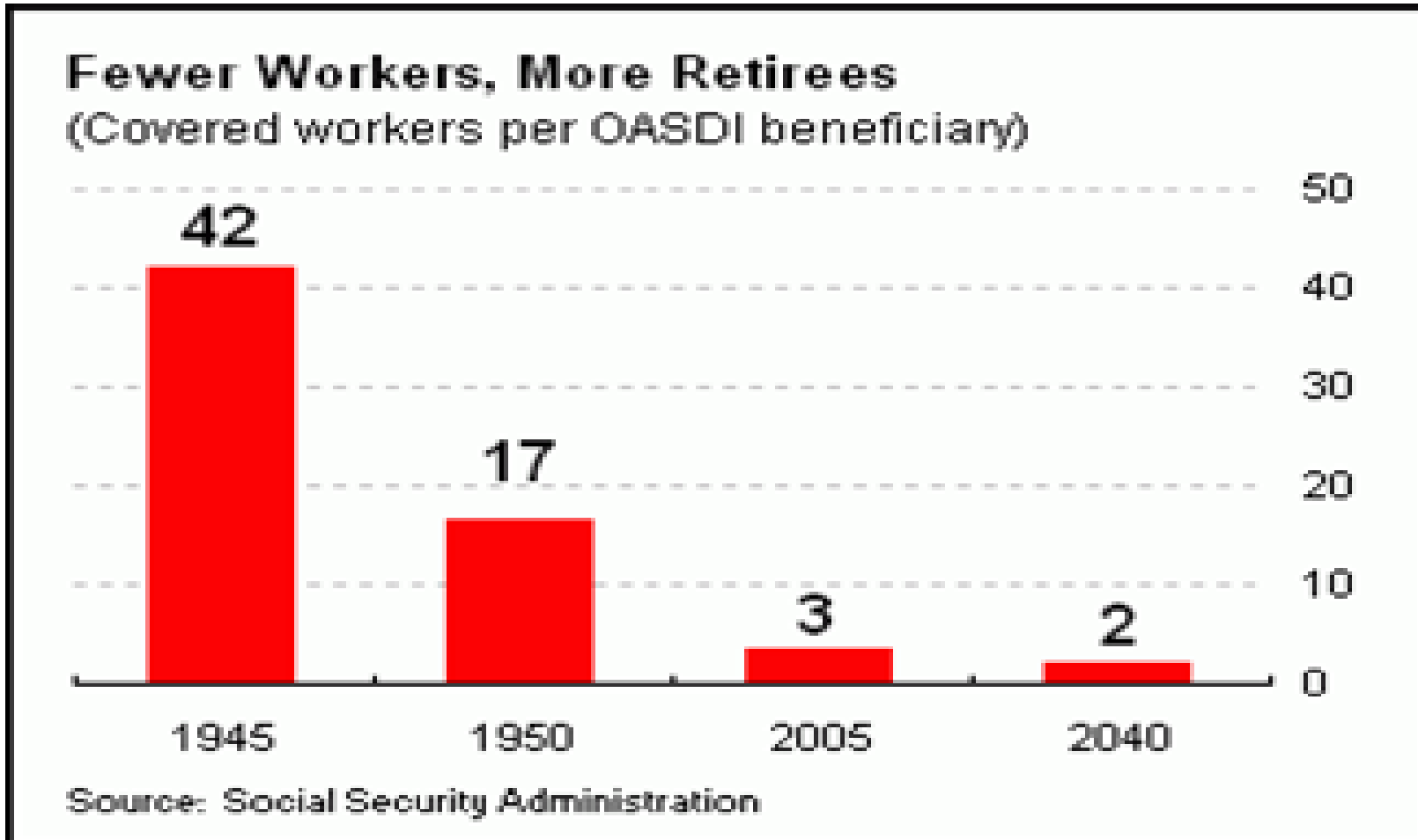


Source: Social Security Administration

Declining Worker Per Retiree

- A pay as you go system, one in which today's workers are financing the retirement of today's retirees, with this aging of the population just cannot take place.
- 42 workers per retiree in 1945.
- Today it is 3.3 and
- Soon it will be as low as 2.

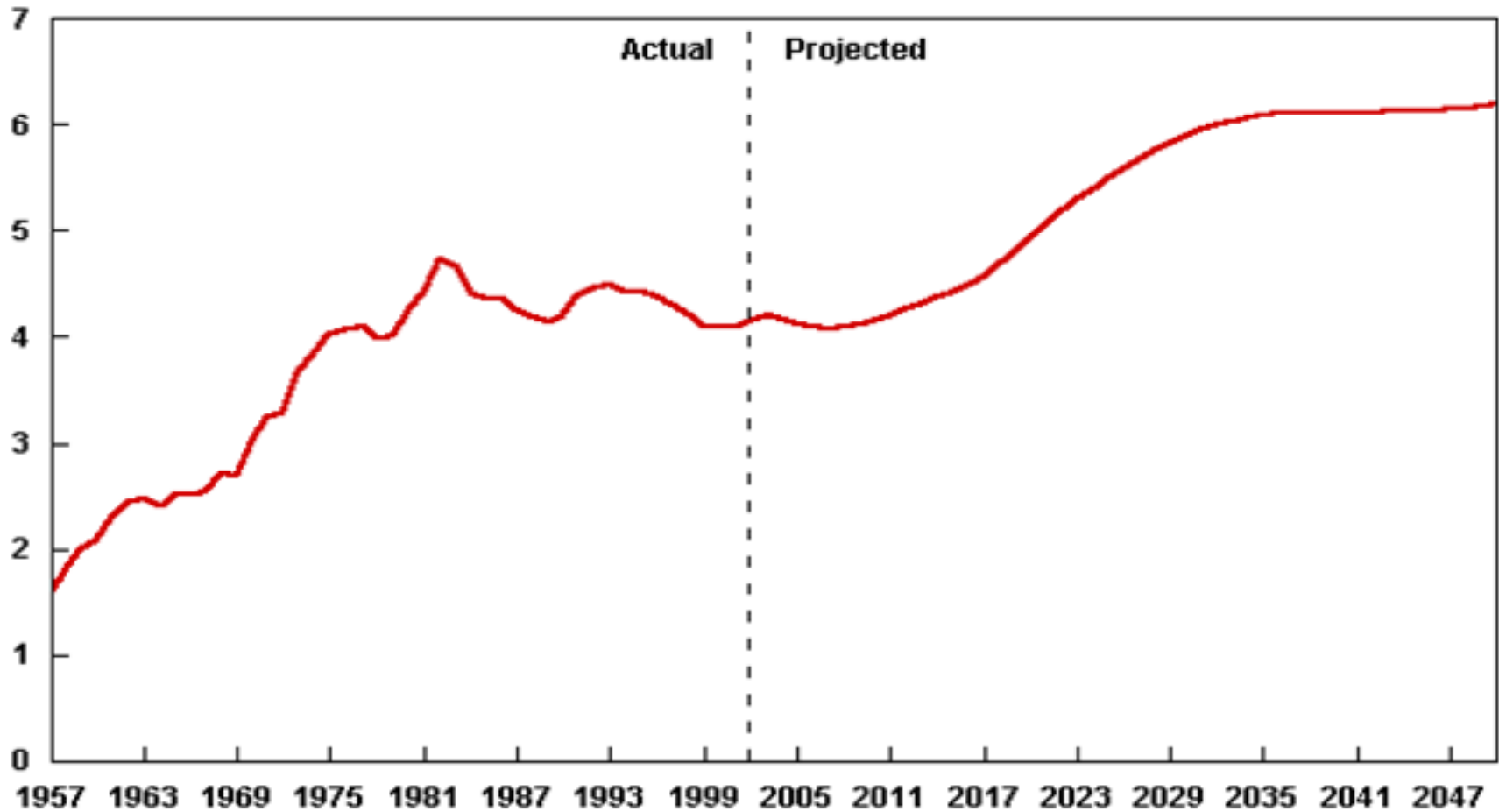
Fewer Workers, More Retirees



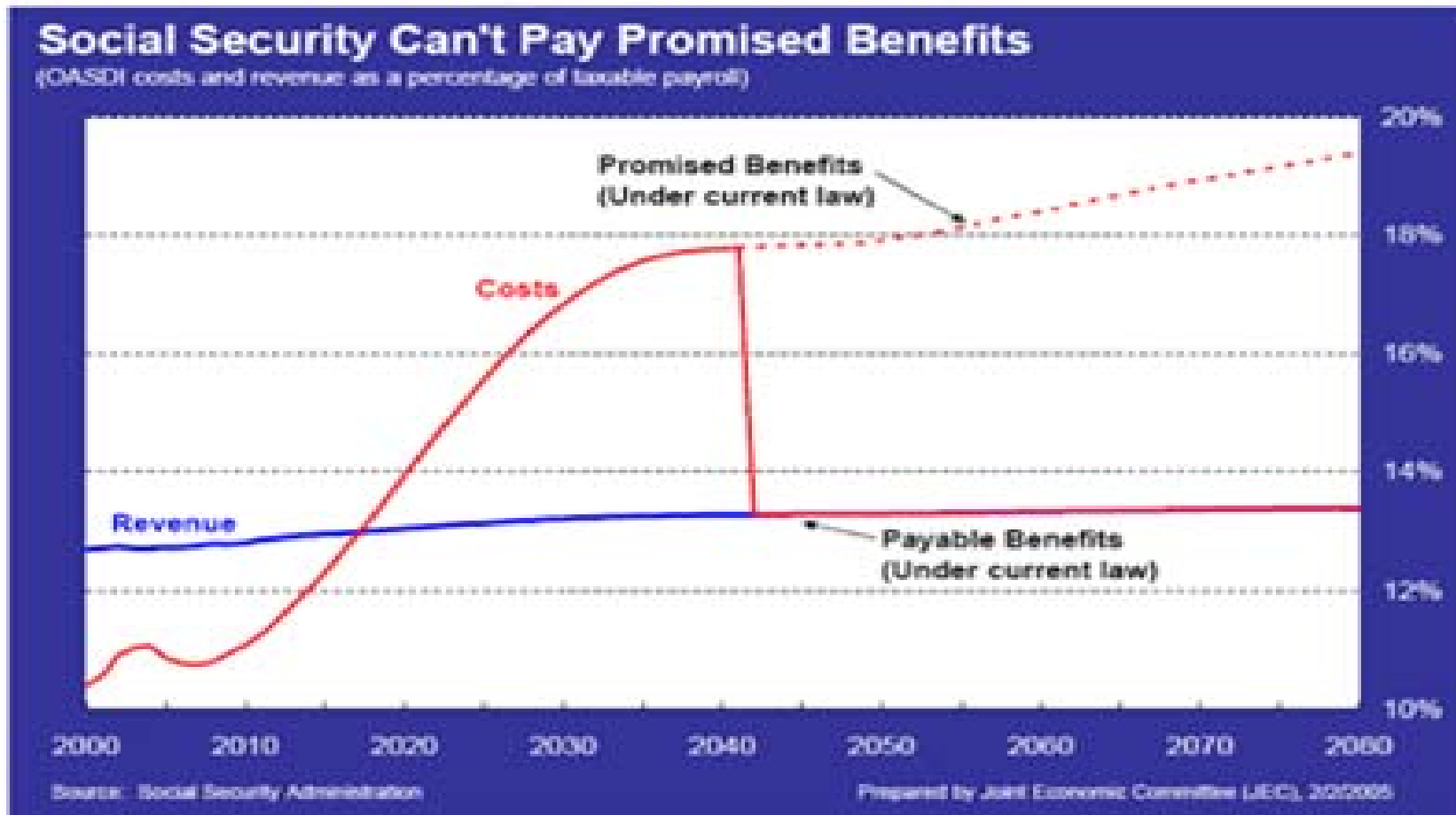
Fiscal Catastrophe on the Horizon

- In the next decade, revenues will fall below benefit payouts.
- Unfunded liabilities exceed \$11 trillion.
- Requires a 35 percent cut in benefits or a 50-80 percent increase in taxes.
- Each year we wait, the problem gets worst to the tune of \$600 billion per year.

Unsustainable Rise in SS Spending

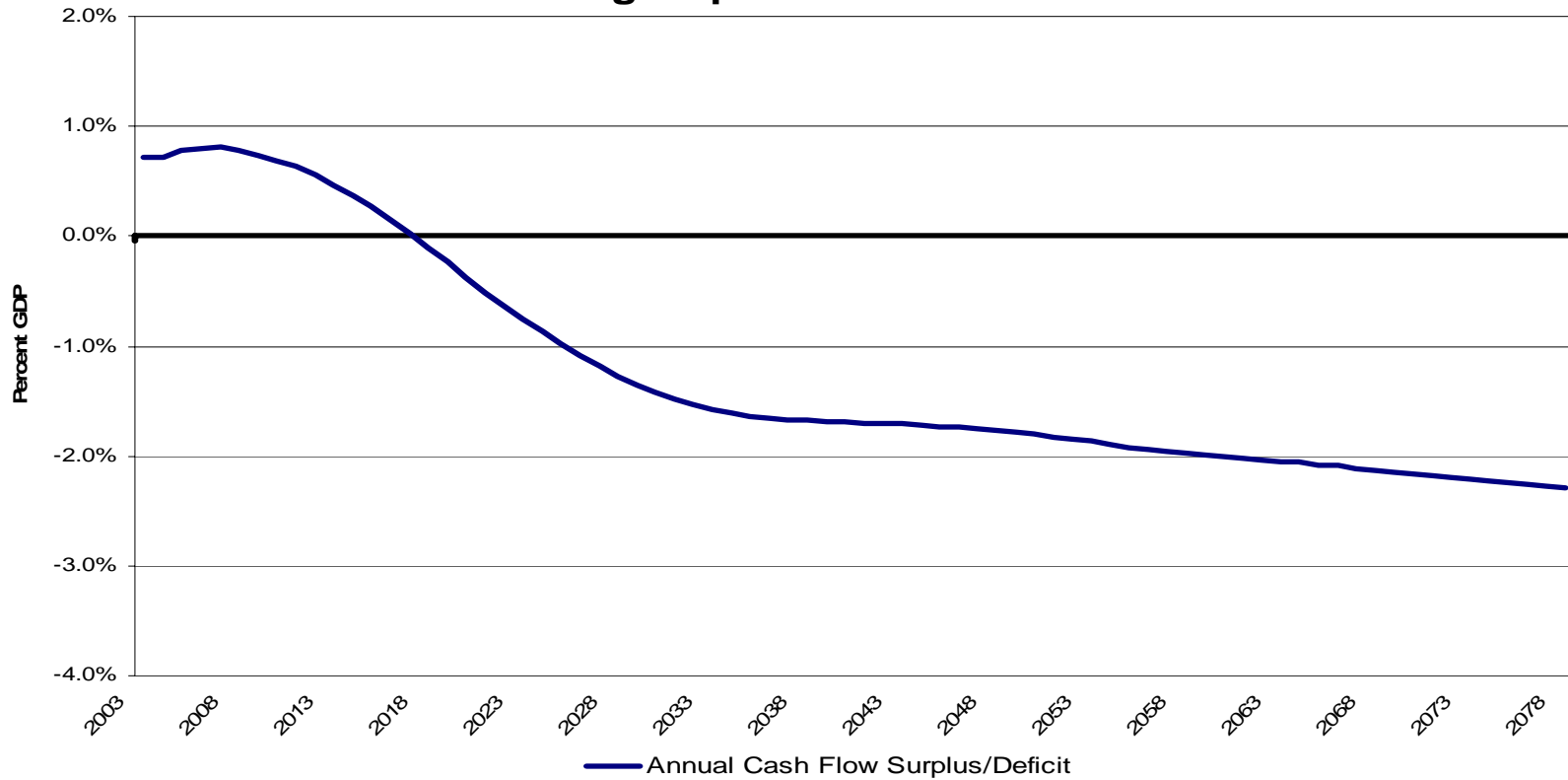


Wide Gap Between Promised and Payable Benefits

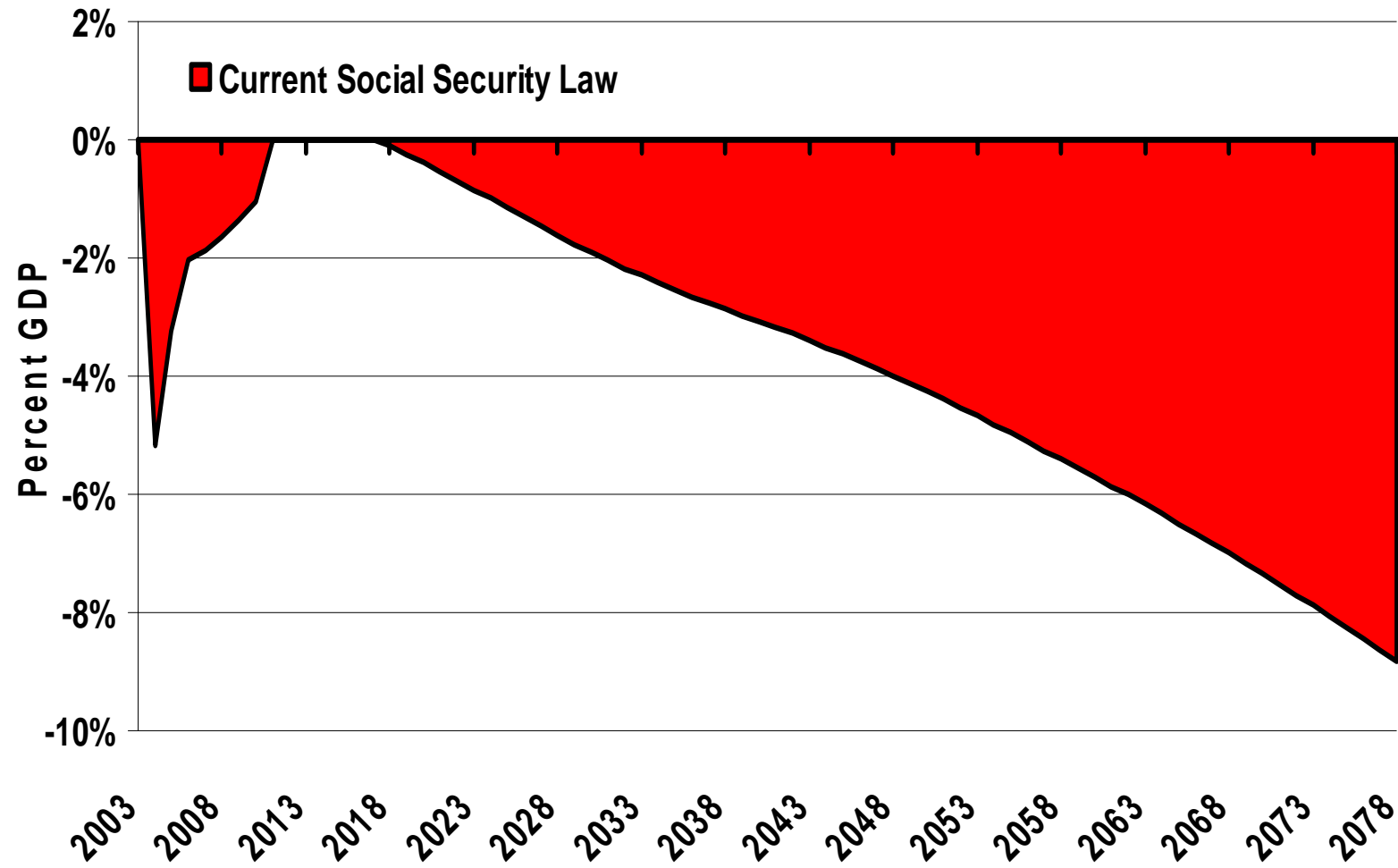


A Perpetual and Unsustainable Financing Gap Exists under Current Social Security Law

Annual Social Security Financing Gap under Current Law

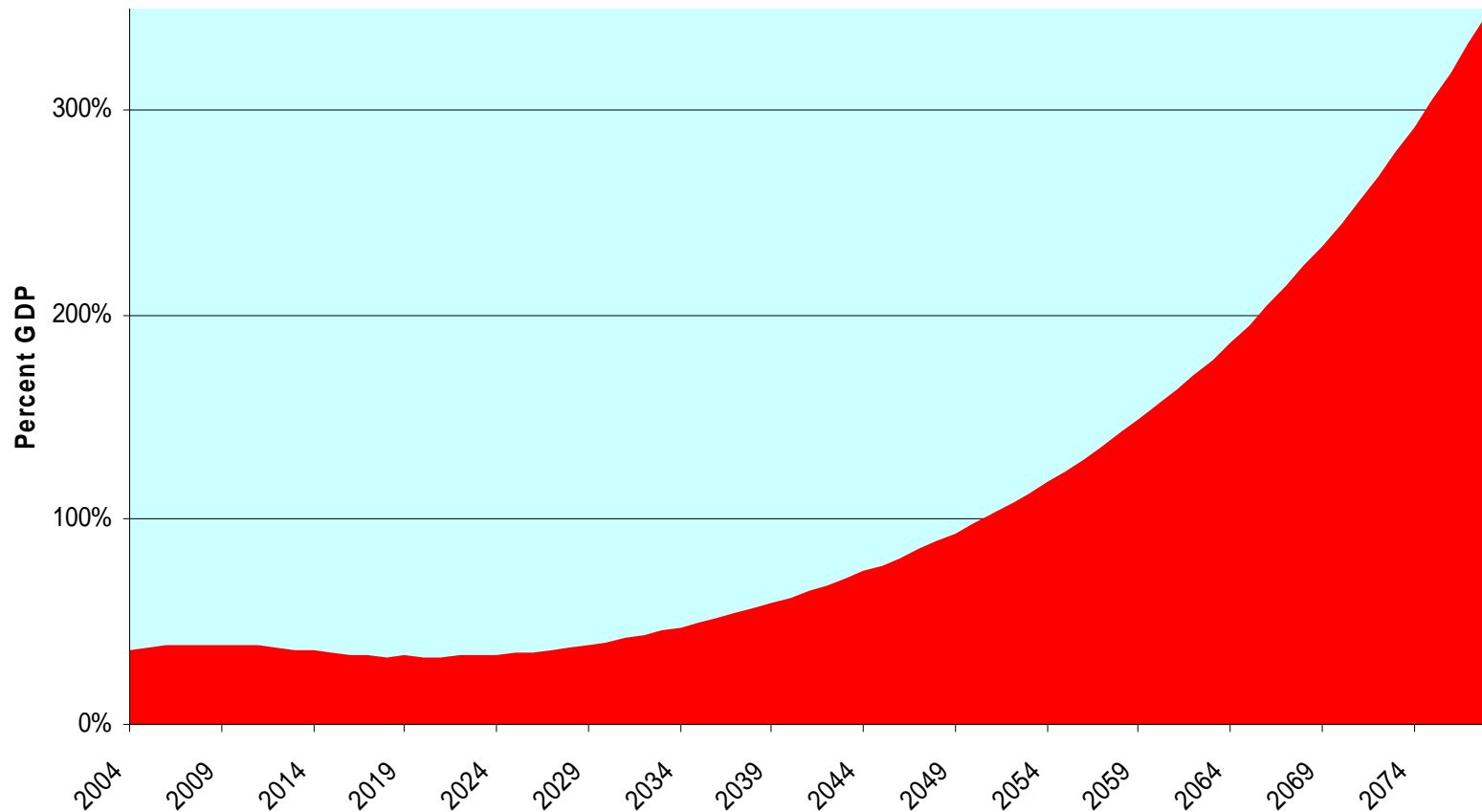


Annual Budget Deficits Would Increase Forever

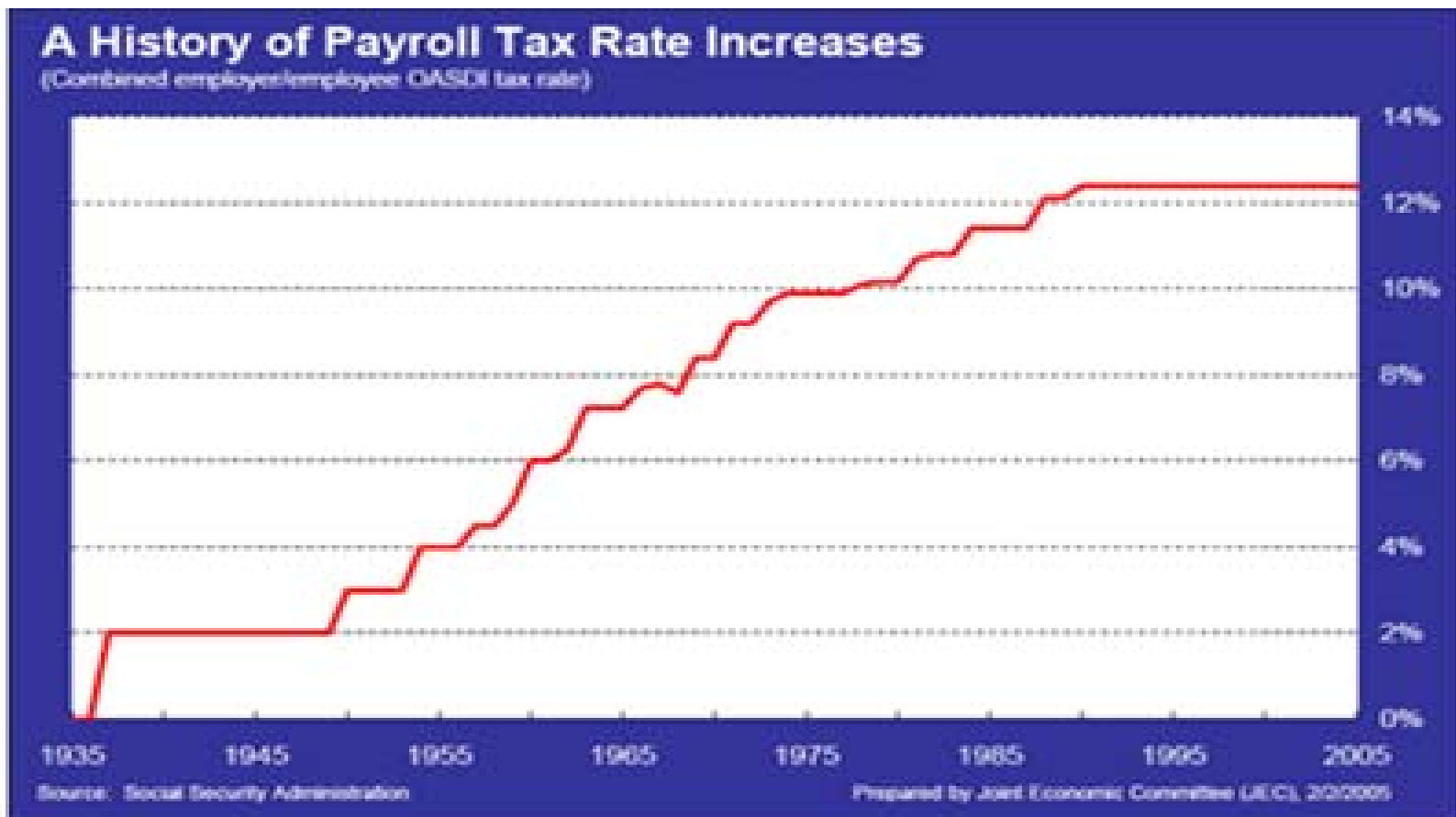


Public Debt To Pay Promised Benefits

■ Debt Projection of Social Security (Current Law)



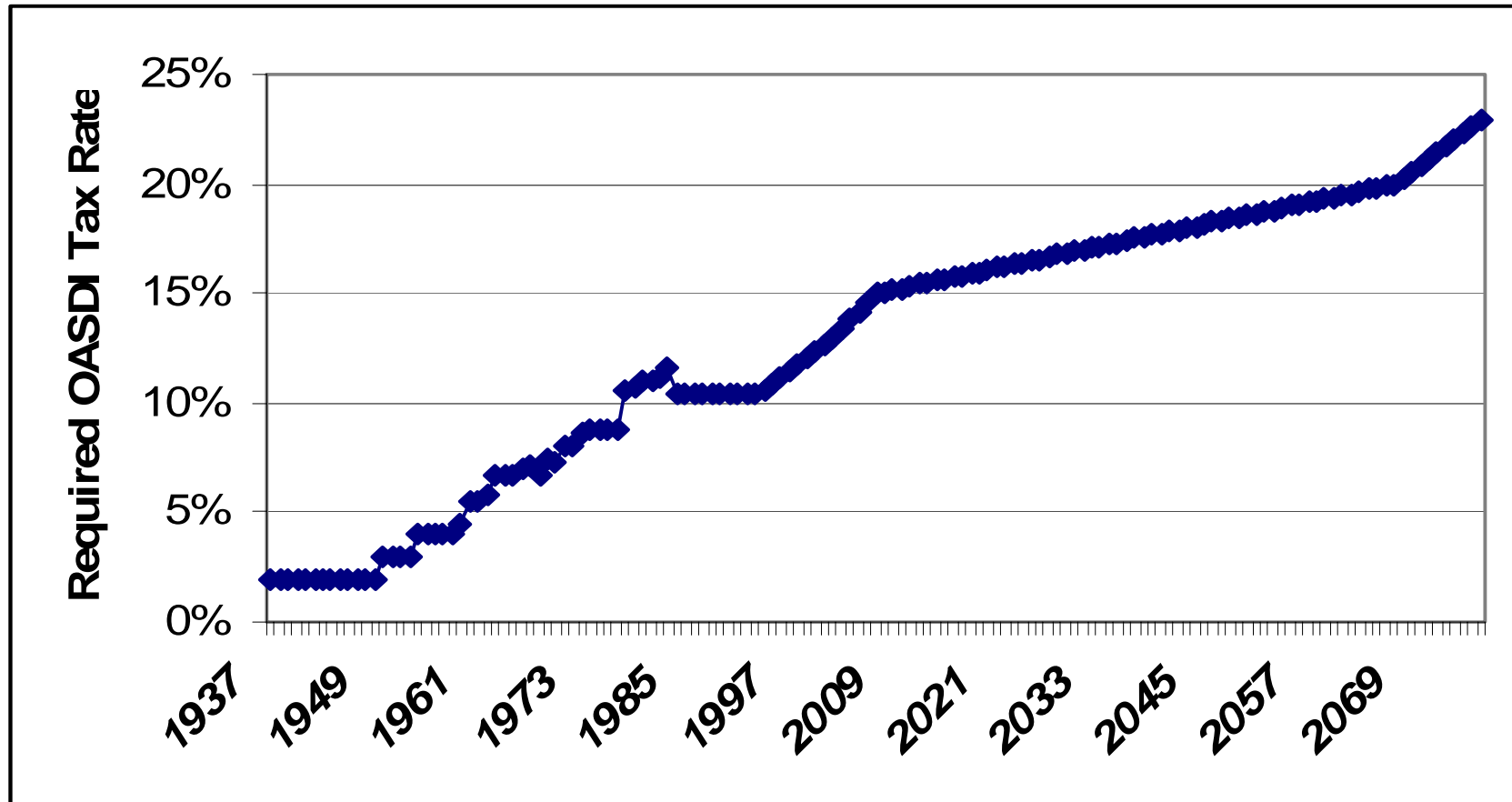
Tax Increases Have Never Worked To Shore Up SS



1983 Was Sold As Making Social Security Solvent

	<i>Pre-1983 Greenspan Commission</i>	<i>Today's Law</i>
Social Security tax rate	10.6%	12.4%
FICA wage base	\$32400	\$90000 (2005 , indexed)
Retirement Age	65	67 by 2027
Taxable Social Security Benefits	No benefits taxable	85% for single filers making more than \$34000
Maximum Social Security Tax	\$3434	\$11160

Taxes Will Rise Significantly to Cover SS Costs



The “Other” Problem With Social Security

- Social Security offers a horrible return for workers.
- As the demographic crunch reduces the worker to retiree ratio, the rate of return for younger workers is declining rapidly.
- In other words, for each dollar a worker receives back in Social Security payments is less than 1 percent and turning negative.
- As a result, the Social Security system itself is making younger workers poorer.

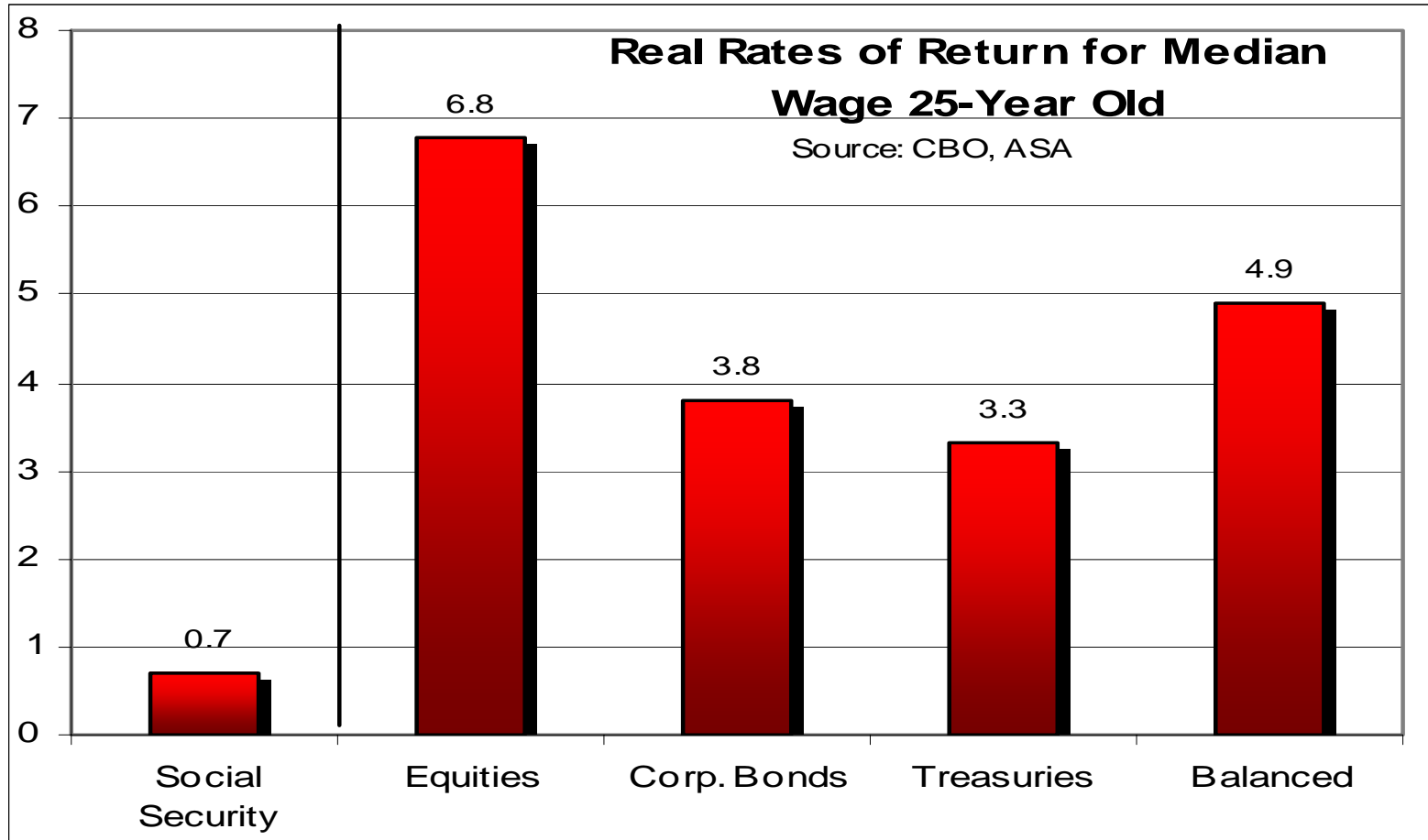
The “Other” Problem With Social Security

- The restrictions not to invest in higher returns are punishing younger workers and families.
- By placing money in a higher return personal account, workers can receive four times as much retirement income than what the present system currently promises but cannot pay without a 50 percent tax increase.

Increasing Retirement Income For America's Workers

- A single 25-year old earning the median wage is *promised* a rate return on Social Security of less than 1 percent per year.
- Yet, to even receive those benefits, taxes will have to be raised 50 percent, further lowering that person's return.
- Conversely, a balanced portfolio will generate an annual return 7 times greater than what Social Security promises, but cannot even pay without significantly damaging the economy.

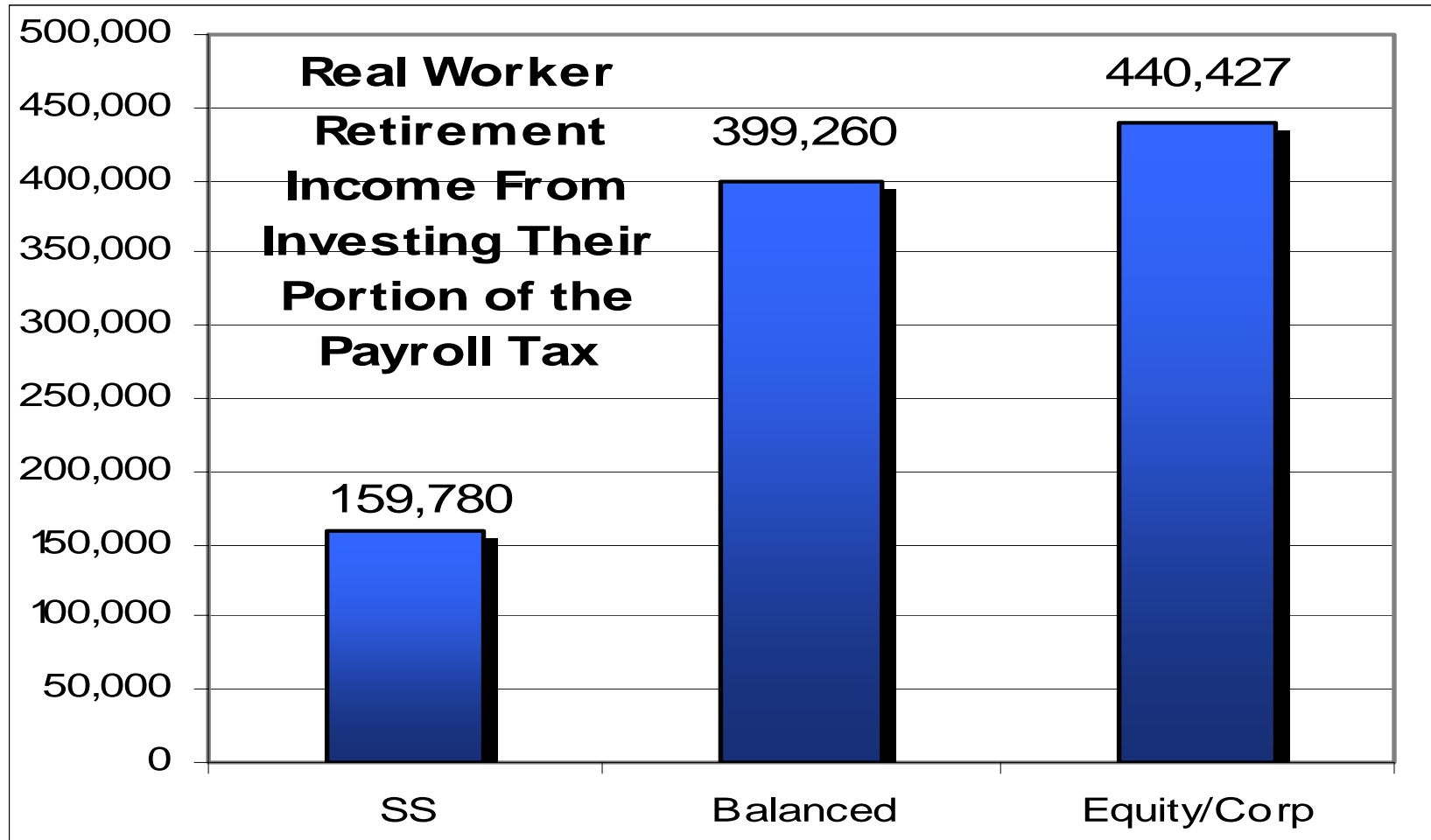
Comparing Rates of Return



Higher Retirement Income

- The difference between what Social Security promises to pay compared to a balanced portfolio is enormous.
- If the worker portion of their payroll tax (6.2 percent) was invested in the balanced portfolio (50% equity/ 30% corporate bond/ 20% Treasuries), that worker would retire with more than \$399,000.
- In contrast, that same worker with a normal life expectancy is set to receive a benefit stream of just \$160,000 (in today's dollars) from the current system.

PRA's Boost Retirement Income



Increased Wealth Creation

- The reallocation from the low return government sector to high return equities and corporate bonds will lead to the largest rise in wealth creation in American history.
- The Social Security Actuary determined after the first 15 years, \$7.8 trillion of wealth (in today's dollars) will be held in workers personal accounts – accounts that workers own and control themselves, unlike the current Social Security program.
- To place this number in context, the combined holdings of the entire mutual fund industry today is roughly \$8 trillion.

Restores Solvency

Social Security Large Personal Accounts Bills Scored to Be Solvent

Social Security Personal Savings Guarantee & Prosperity Act (Ryan-Sununu)

www.house.gov/ryan

Progressive Proposal for Social Security Personal Accounts (Ferrara scored paper)

www.ipi.org

Social Security Guarantee Plus Act of 2005 (HR 750: Shaw)

shaw.house.gov

Social Security Savings Act of 2003 (Demint, 108th Cong, HR 3177)

Thomas.loc.gov

Private Pensions

Private Pensions

Warren Buffet once said:

*“You Don’t Know Who’s
Swimming Naked Until
The Tide Goes Out”*

Uncertainty Over Pension Amount or Over the Pension Itself?

- At the current rate, workers have the potential to lose their pension plans if sufficient tax increases are not enacted (private sector: airline cutting DB benefits 2/3)
- Under DC, the amount maybe uncertain, but what is certain is something will be there, unlike in DB plans today.

Don't Let Perfect Be The Enemy of Good

- Opponents of DC Plans Have Raised Important Concerns.
- Concerns Can Be Easily Fixed, Since Most Are Small Changes.
- In Contrast, DB Plans Will Wane In Importance Because of Structural Problems
- It Makes No Sense To Shoot Down What Is Best for Employees Over These Small Concerns

The DC Solution

- An aging population, increased labor mobility, perverse incentives of the public pension system, and taxpayer frustration has led to a new reality facing pension systems.
- Defined contribution plans are the natural alternative to meet these changing needs.
- Merging attractive features of a DB plan with individual ownership meets these needs.

DB Features in the DC Plan

- Automatic Enrollment in the DC Plan
- Index Funds Provide for Portfolio Diversification:
- [Equity, Bonds, Cash] [Large Cap, Small Cap, Mid Cap] [Value, Core, Growth] [Domestic, International]
- Lifetime Fund option managed professionally
- Annuities Upon Disbursement, Unless IRA Roll Over

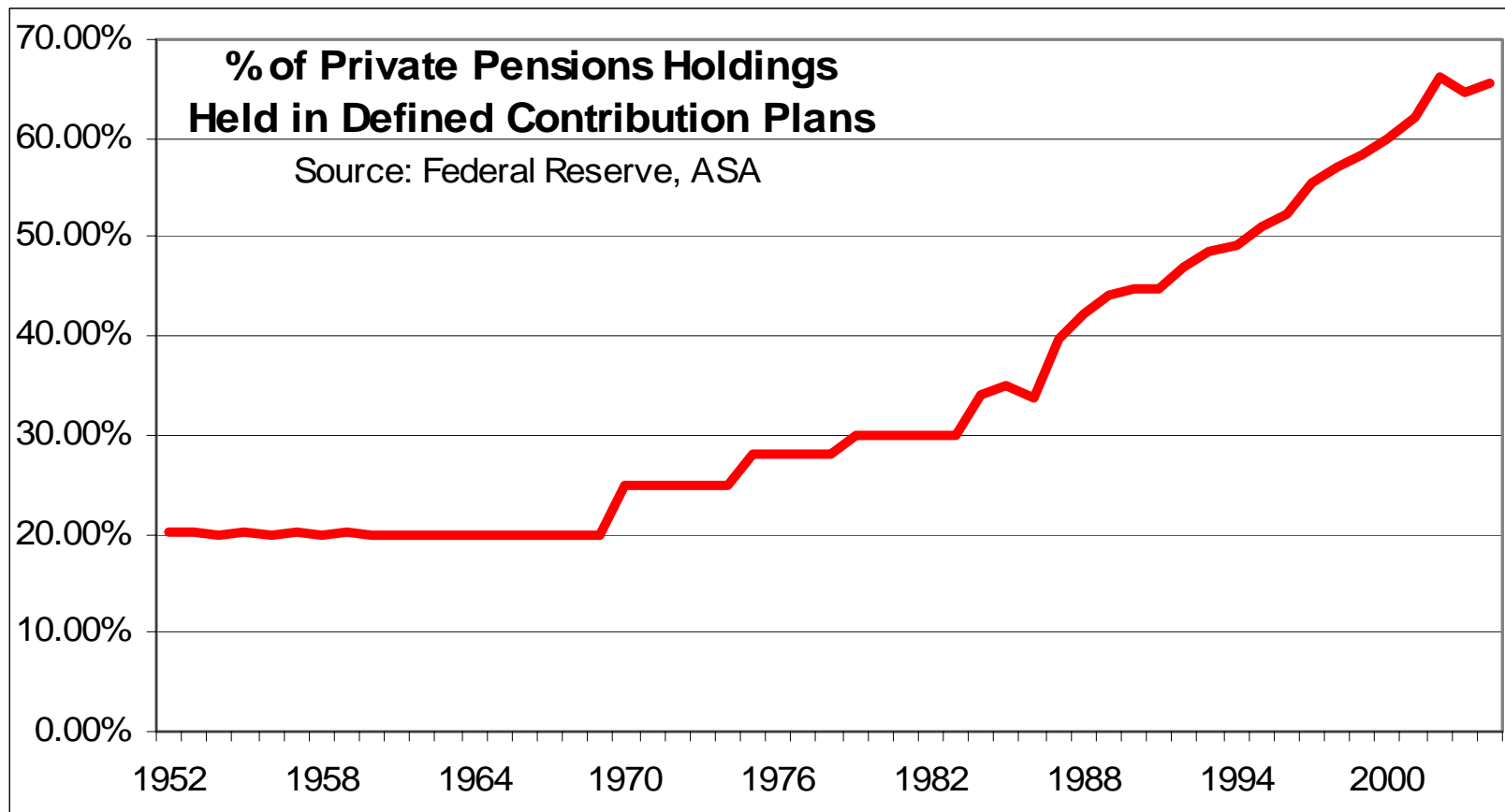
Benefits to Workers:

- The DC Plan is Fully Portable.
- Workers Control Their Own Funds.
- Worker Empowerment.
- Higher Returns for Workers, Especially Short and Mid Term Workers.

Benefits to Taxpayers:

- Unfunded Liability Hemorrhaging Ends
- Prevents Need for Taxpayer Bailout like S&L Crisis

DC Plans Represent 2/3 of Private Pension Holdings Already



The Coming Pension Storm

- Severe Under Funding of Pension Plans (\$450 billion estimated)
- Long time horizon of pensions creates severe risk and uncertainty (i.e. GM)
- PBGC has \$23 billion of unfunded liabilities
- Expected to grow to \$78 billion
- More bankruptcies leads to more exposure – potential S&L crisis on the horizon

Four Options

- Taxpayer Bailout similar to S&L
- Force companies to increase payments to retirement plans
- Raise PBGC premiums
- Raise premiums more for “at risk” companies

Options Will Increase DC Use

- No matter which way it is sliced, the combination of the three options included in the pension legislation will accelerate the use of DC plans.
- The shift has already begun with a number of companies freezing their plans.

New Wave of DC Plans Coming

- Of S&P 500 companies, 207 have pension plan obligations that exceed \$1 Billion.
- Many companies have greater pension obligations than cash on hand.
- Implementation of policy forces companies to realize the cost of DB plans earnings pressure will push to DC plans.

Companies With Less Cash Than Under Funded Obligations

S&P 500 Cos. with Lowest Ratio of Cash-to-Unfunded Pension Liabilities
 (S&P 500 excluding Financials with Pension Obligations Greater Than \$1 Billion (\$US)
 and Obligations Underfunded by More Than 25%, Data in \$US MMs)

		Plan Obligations	Plan Assets	Obligations minus Assets	Pct. Unfunded	Cash % Unfunded Obligations
APD	Air Products & Chemicals	\$2,755.0	\$1,777.0	\$978.0	-35.5%	7.2%
BLL	Ball Corp.	1,285.4	756.4	529.0	-41.2	11.5
MYG	Maytag	1,866.5	1,286.9	579.5	-31.0	12.5
NYT	New York Times Co.	1,397.3	1,039.5	357.8	-25.6	12.5
CCE	Coca-Cola Enterprises	2,576.0	1,810.0	766.0	-29.7	14.0
BNI	Burlington Northern	1,710.0	1,276.0	434.0	-25.4	17.3
CIN	Cinergy Corp.	1,698.0	1,021.0	677.0	-39.9	21.6
JCI	Johnson Controls	2,795.1	2,083.1	712.0	-25.5	23.5
ROK	Rockwell Automation	2,520.7	1,680.0	840.7	-33.4	29.3
NWL	Newell Rubbermaid	1,326.4	950.4	376.0	-28.3	30.7
KR	Kroger Co.	2,132.0	1,458.0	674.0	-31.6	35.2
PH	Parker Hannifin	2,593.7	1,749.8	843.9	-32.5	37.1
ETN	Eaton Corp.	2,601.0	1,852.0	749.0	-28.8	44.9
EMN	Eastman Chemical	1,382.0	878.0	504.0	-36.5	56.7
LLL	L-3 Communications	1,131.6	734.6	397.0	-35.1	57.0
SYG	Sysco Corp.	1,574.7	1,141.6	433.1	-27.5	58.6
ASD	American Standard Cos.	1,691.1	1,031.5	659.6	-39.0	59.2
AV	Avaya Inc.	3,451.0	2,289.0	1,162.0	-33.7	62.5
CL	Colgate-Palmolive Co.	2,044.1	1,508.2	535.9	-26.2	63.6
ABS	Albertsons Inc.	1,234.0	893.0	341.0	-27.6	74.8
BAX	Baxter International	2,838.0	1,739.0	1,099.0	-38.7	76.5
GT	Goodyear Tire & Rubber	7,720.3	4,598.3	3,122.0	-40.4	77.2
ETR	Entergy Corp.	2,633.4	1,872.7	760.7	-28.9	78.6
AYE	Allegheny Energy	1,108.8	765.4	343.4	-31.0	82.6
SHLD	Sears Holdings	2,743.0	1,739.0	1,004.0	-36.6	91.8

Public Pensions

- 8 out of the last 10 major changes to state pension plans have been shifts from DB to more DC oriented plans.
- States are doing this in response to growing budget, demographic, and economic pressures.
- These costs will escalate in the future thus more states will be moving to DC plans.

Cost of Defined Benefit Plans

Perverse Incentives

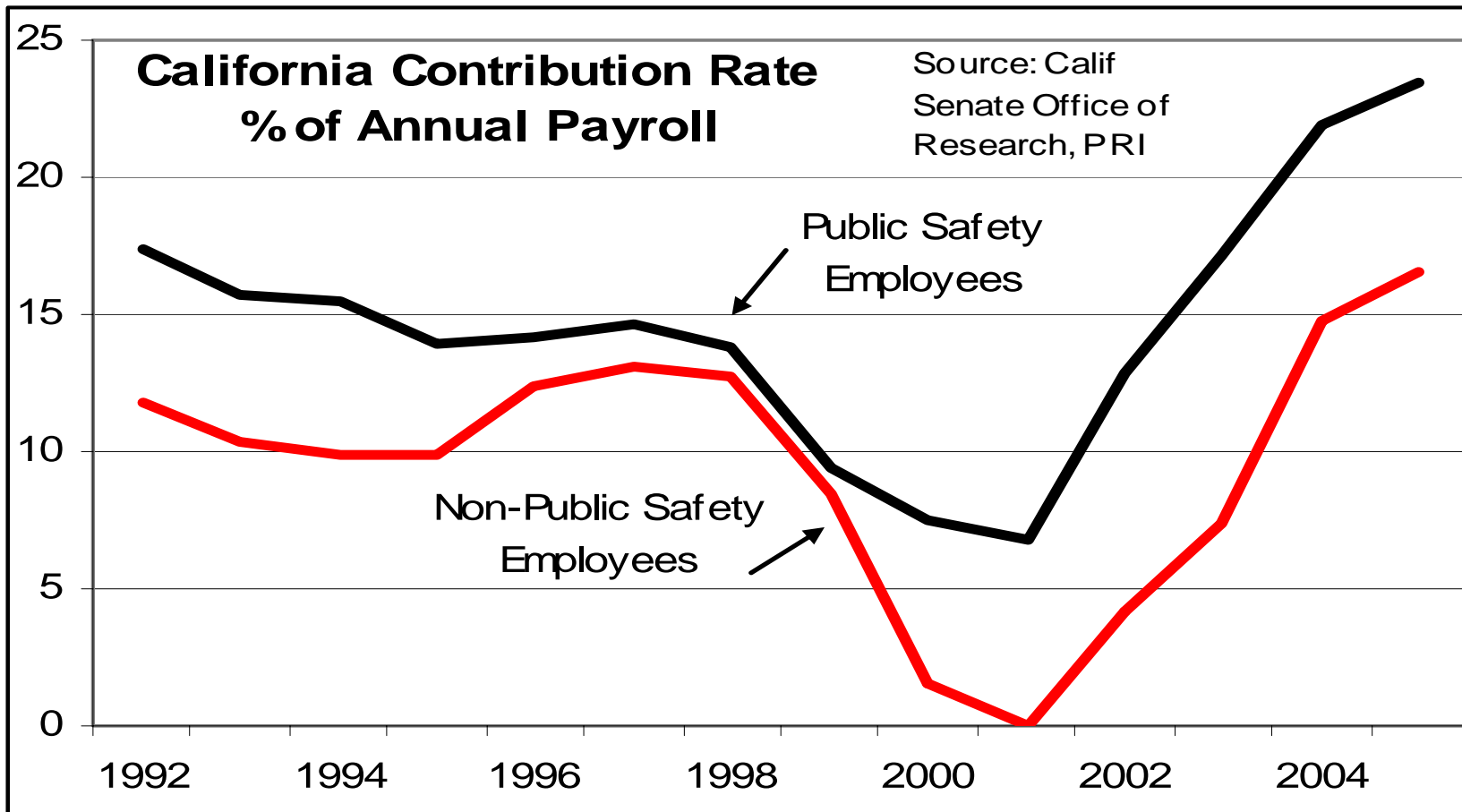
1. Pension fund used by politicians to raise benefits during good economic times
 - Employers/Employees were not paying for these benefits during their workers lifetime
 - Paid for from existing plan assets and therefore, increasing the unfunded liability.
 - Not subject to ERISA requirements which makes it easier to enhance benefits w/o funding.

Cost of Defined Benefit Plans

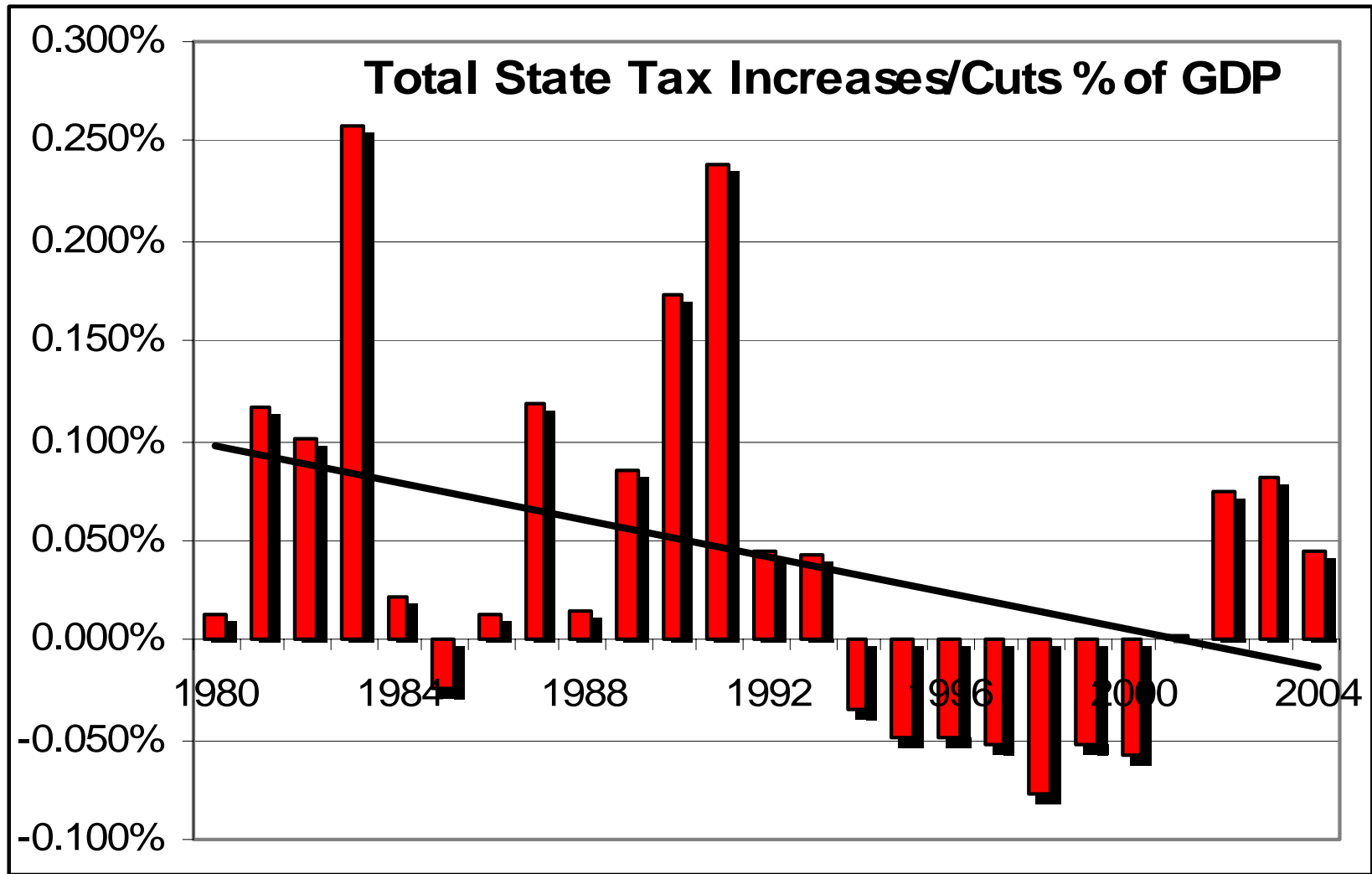
Perverse Incentives

2. DB plans require greater contributions at exactly the worst time - when economy/markets are dropping
 - Leads to increased taxes which are not politically popular or,
 - Under funding of required contributions

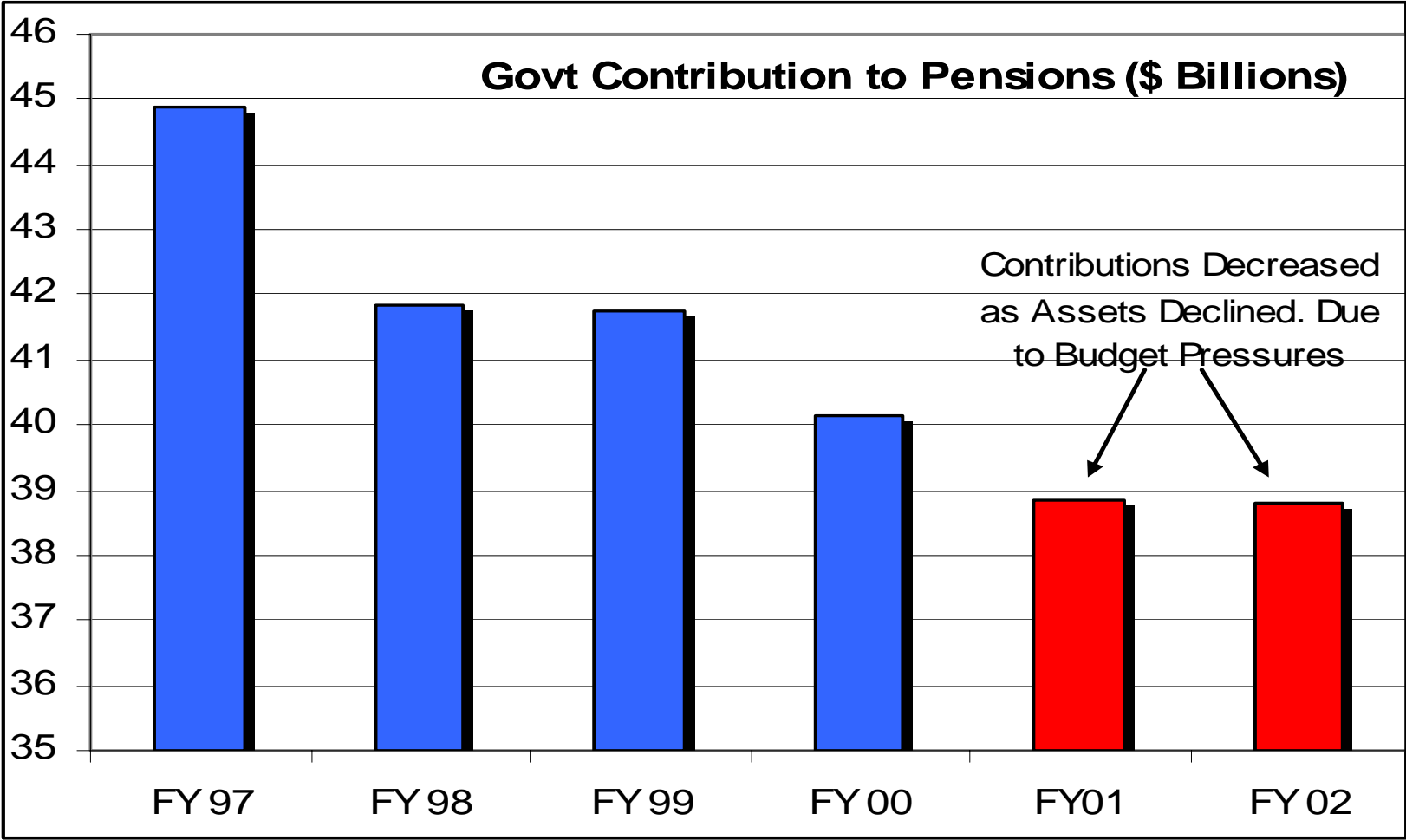
Annual Contributions Are Unpredictable



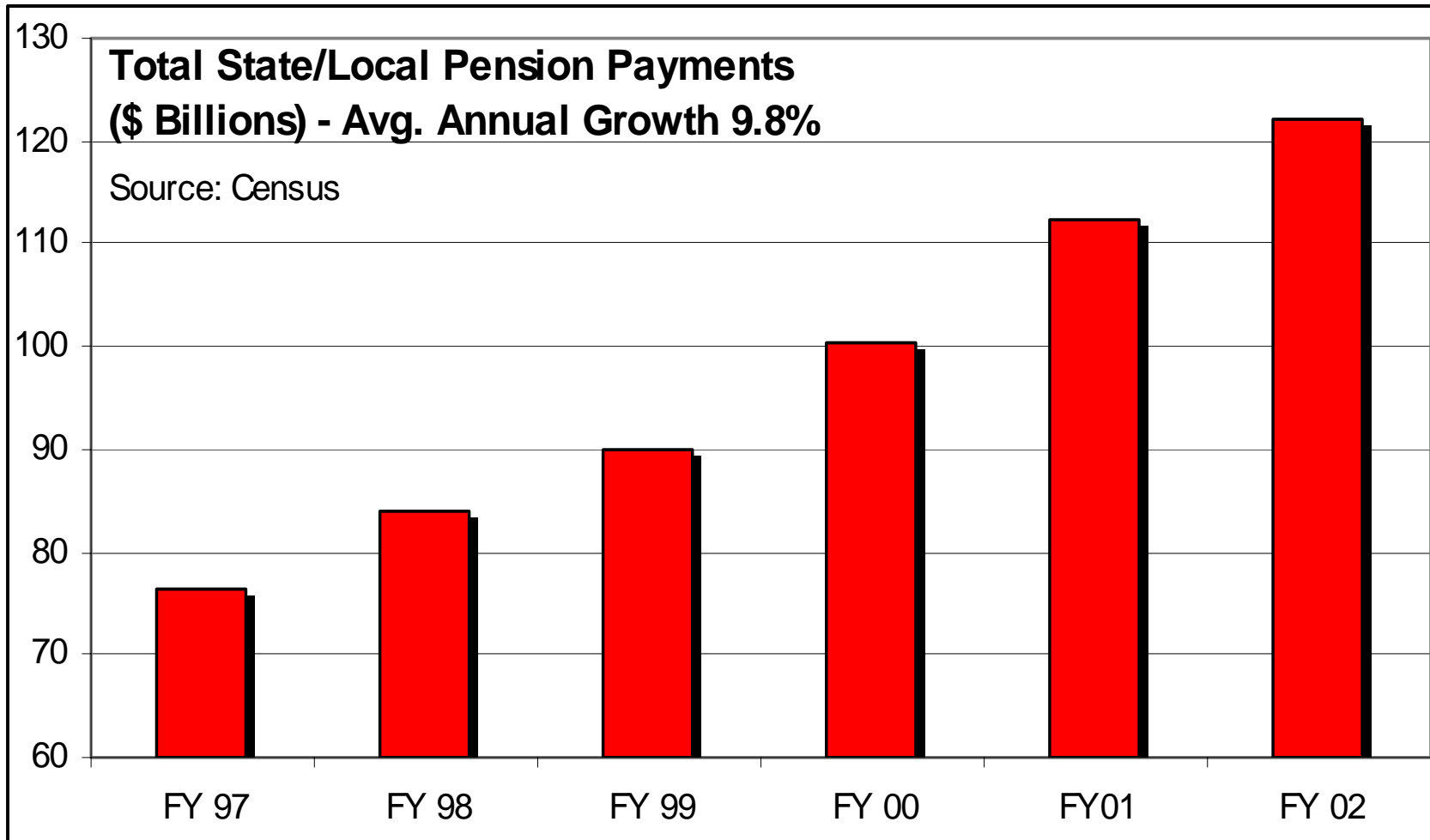
States Less Willing to Raise Taxes



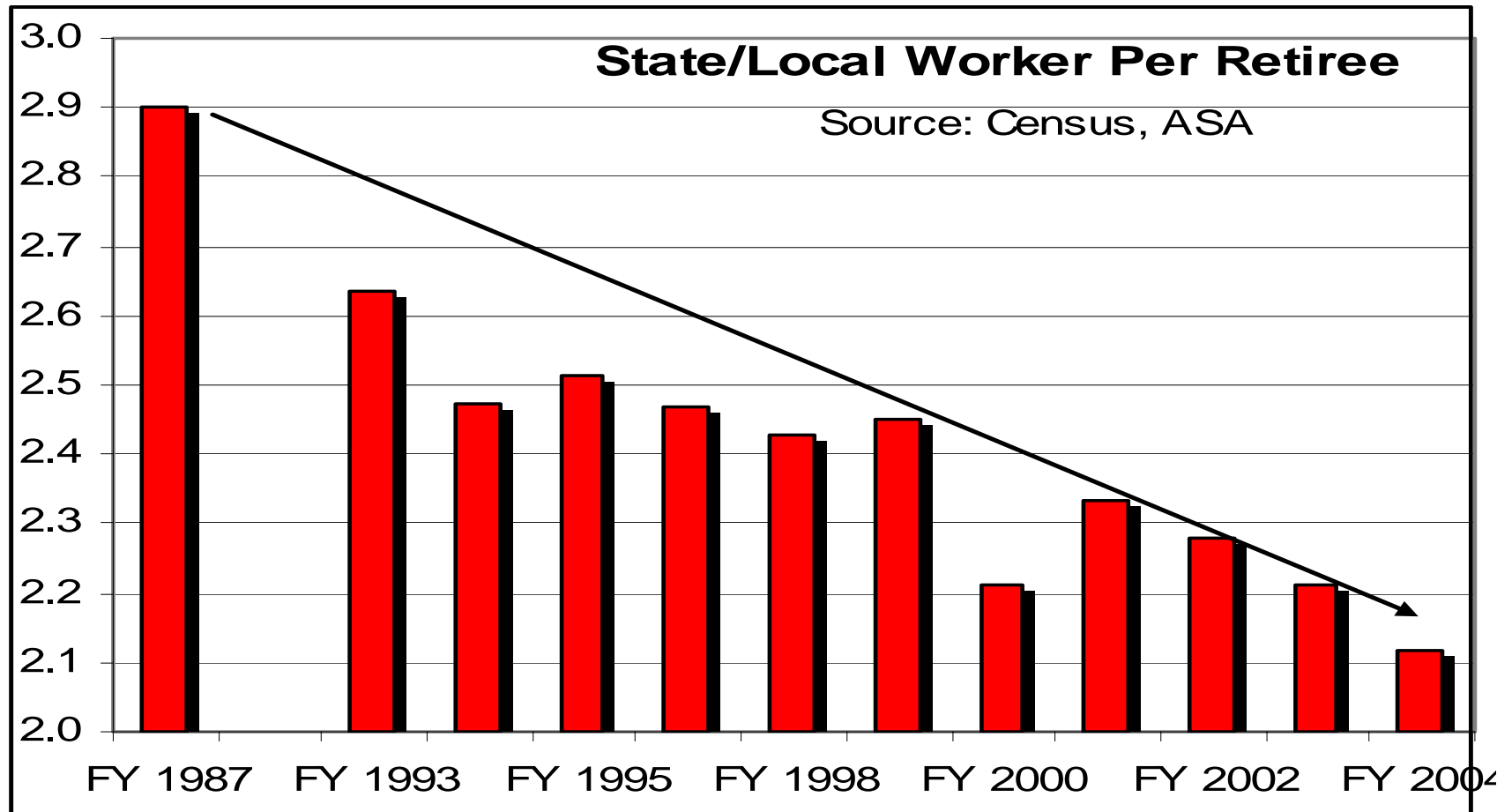
Pension Contributions Frozen In Recession Due to Deficits...



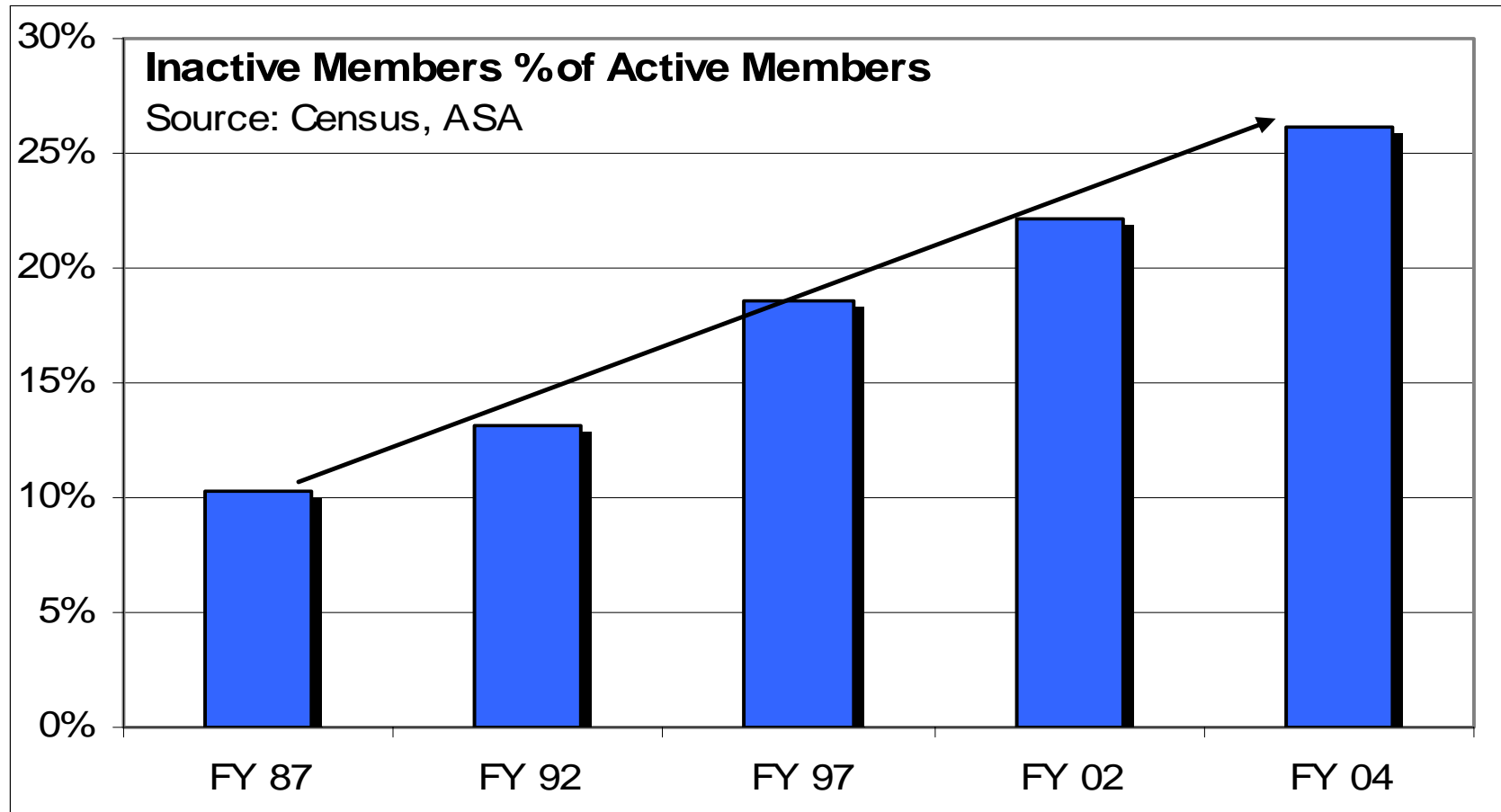
... While Payments Soared



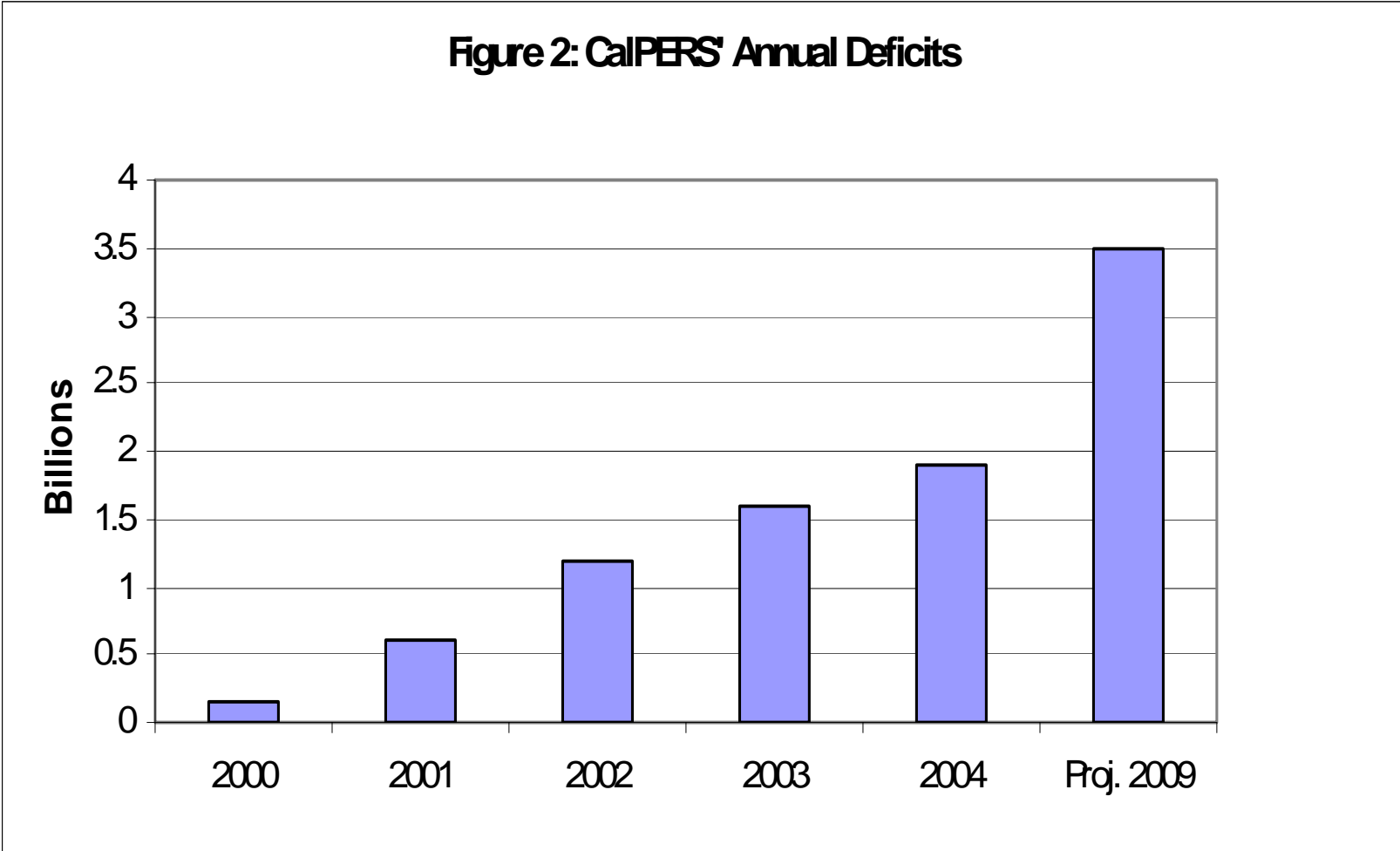
Retirements Already Rising, Acceleration Expected



Inactive Members More Than Doubled in 15 Years



Now Is The Future: Structural Deficits Have Arrived



Countering the DC Myths

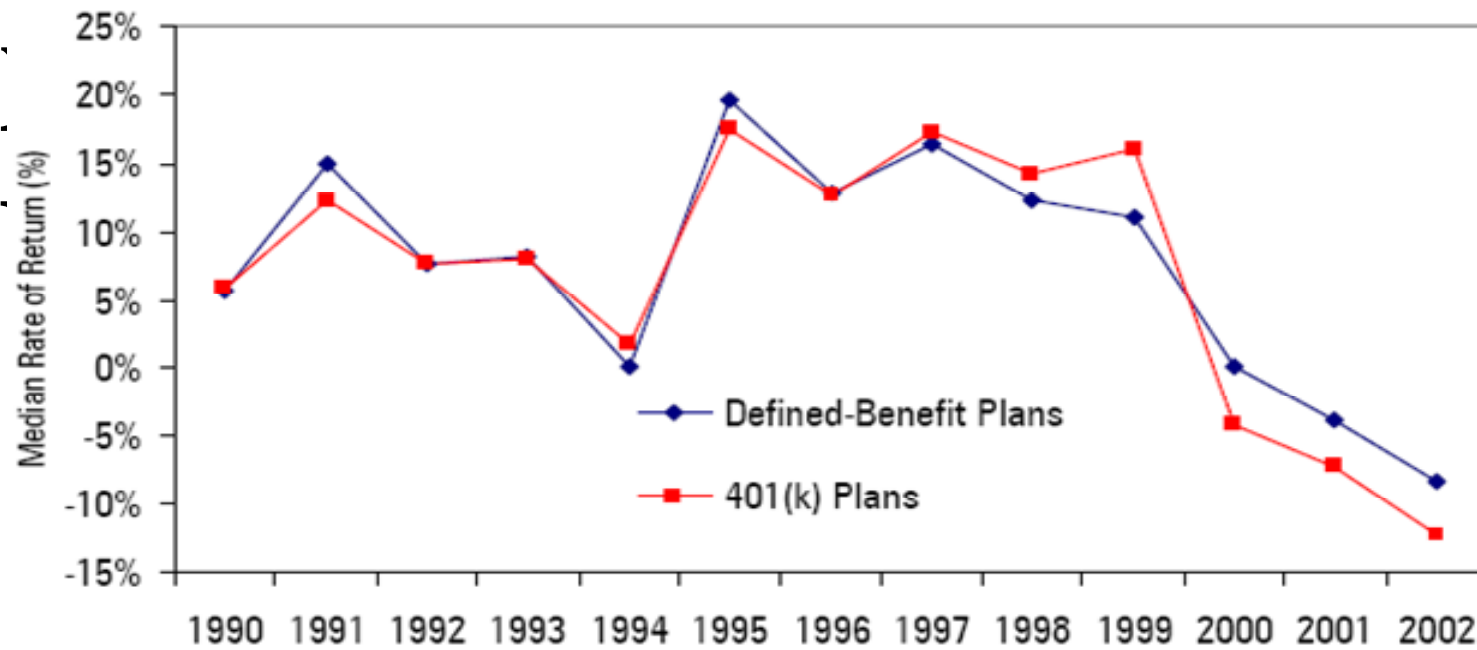
“Warren Buffett Myth”

New Trends Make It Easier to Invest

- Use Federal TSP program as a model
- 5 or 6 index funds for broad portfolio diversification, tracking indexes.
- Growing popularity of ETF's make this possible.
- Even w/o ETF's rates of return for DB and DC are very similar

Similar Rates of Return

Figure 4: Median Rates of Return for Defined-Benefit and 401(k) Plans, 1990-2002



Source: Watson Wyatt & Co., "Defined Benefit vs. 401(k): The Returns for 2000-2002," Watson Wyatt Insider, October 2004.

Not Enough Retirement Income Myth

- Making the right comparison between DB annual payments and annuity payments demonstrates workers have more retirement income under DC.
- This is particularly true for shorter term workers, who benefit from the accruing gains over their careers.
- Pacific Research Institute analysis of CALPERS benefit v. DC plan shows nearly every state employee benefits under DC.

Administrative Cost Myth

- Proponents claim administrative costs are lower under DB plan and focus only on investing accounts.
- Fails to take into consideration the costs to administer the program itself

Administrative Cost Myth Part II

Ignoring Low Fee Investment Alternatives

- Proponents argue pool investment fees are less than under traditional mutual fund (20 basis points compared to 180-200 basis points)
- However, Federal TSP operates at 15-20 basis points.
- Movement toward ETF's – 15 to 20 basis points. (Some quirks need to be worked out)