The Proliferation of Pension Regulations

Kathleen P. Utgoff

The proliferation of federal pension regulations, which accelerated in the mid-1980s, has undermined the incentive for employers to provide pension plans, particularly defined benefit pension plans. The proportion of workers covered by a defined benefit plan has declined substantially, and few new private defined benefit plans are being created. This has both reduced the ability of employers to structure long-term work arrangements and shifted more of the investment risk of providing retirement benefits to the individual worker. The proliferation of pension regulations, much of which was designed to reduce risk to covered workers, has had the unintended effects of limiting the proportion of workers covered and of increasing their risks.

Background Conditions

Since 1970 there has been a dramatic trend toward early retirement. While legislators were working to make sure that no one was forced to retire, older workers and not-so-old workers left the labor force in droves. The labor force participation rates for two groups of male workers—age 65 and over and ages 55 to 64—fell a full percentage point per year between 1970 and 1985. Now, less than 15 percent of males over 65 are in the labor force and only two-thirds of males between 55 and 65 still work.

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Some of this pattern can be explained by large, unanticipated increases in Social Security benefits, but that is not the only explanation. Richard Ippolito's study of retirement behavior points out that much of this reduction can be explained by changes in the early retirement provisions of private pension plans. In 1960 only 8 percent of workers covered by a pension could retire with full benefits before age 60, by 1983 over half could.

Given that our changing demographics have begun to produce a dearth of new workers, it is easy to imagine that personnel managers across the country are being called on to undertake a major overhaul of their pension plans to encourage later retirement. For the most part, however, the scene in corporate boardrooms and executive offices is totally different. Executives who are responsible for pensions are busy explaining the expenditure of hundreds of thousands of dollars on actuaries who were hired to perform thousands of calculations to prove that a firm's current pension plan is in compliance with the law. This executive must then admit that these expenditures do not even buy peace of mind. Pension laws are changed every year. To make matters worse, practical details of those new laws are left to three different federal agencies to implement through regulations. But many of these regulations have never been published, although the penalty for noncompliance can be retroactive and draconian.

It is not surprising then that severe myopia and fixation with detail have immobilized corporate benefit departments. Many dedicated executives

cannot think about the future; they are too busy trying to understand, comply with, and explain hundreds of detailed and artificial constraints that must be met to maintain the tax-exempt status of pension plans.

Many of these beleaguered executives remember a time when a pension was a way to provide retirement income to long-service employees and a way to influence turnover that increased overall productivity. But managers cannot talk to their benefit consultants about the needs of employees or the firm any more. As the secretary of the retirement committee at Loyola University told *Institutional Investor* magazine, "I've been in the pension business twenty years, and we're reaching the point where I can't even understand my actuary." A host of new laws has made pension design an increasingly tedious maze. Although the reward for passing through the maze is a substantial tax benefit, many employers are deciding the price is excessive. The percentage of workers covered by a pension, which grew fairly steadily since World War II, has come to a virtual standstill.

To understand how pension plans came to be so restricted in a nation that is worried about a low savings rate as well as an aging population, it is important to distinguish between restrictions that were intended to prevent fraud or protect workers and those that were intended to redistribute income. Although the business community fought both types of regulations and predicted dire consequences for both, it is the regulations that have tried to redistribute income among sex, age, and income groups that have proved to be the most disruptive and burdensome. There is a new wave of legislation on the horizon, however, that threatens to be equally disruptive. This legislation is based on the misguided notion that pension plans, as major owners of corporate securities, have a negative impact on our economy.

All pension regulations are conditional mandates. No employer is required to establish a pension plan. But if a plan is established, several requirements must be met to obtain the tax breaks afforded to "qualified" plans.

Antifraud and Worker-Protection Rules

The primary purpose of the Employee Retirement Income Security Act of 1974 (ERISA) was to prevent fraud and the loss of pension benefits when a business failed. Toward that end, ERISA established requirements to ensure that employees did not have to work for excessively long periods to qualify for a pension. Discharges to prevent the collection of pension benefits were prohibited. Fiduciary rules governing the behavior of people exercising control over the management and investment of pension plans were established. Plans were also required to spell out plan provisions in a written document and to provide information to employees that described the rules of the plan, the financial status of the plan, and benefit accruals under the plan.

Although there is no evidence that ERISA reduced behavior that could be considered fraud, probably because pre-ERISA fraud was rare, the antifraud provisions did not create the regulatory nightmare that exists today. There was an initial spate of plan terminations when ERISA became effective because some employers refused to continue plans under the new rules, but otherwise there were relatively few major complaints once the dust settled.

One continuing source of contention has been the treatment of excess assets in a defined benefit plan. These plans promise a monthly benefit that

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is usually related to length of service and pay levels. Unlike a defined contribution plan, where, once the worker has worked long enough to vest, the assets always belong to the employee, the assets in a defined benefit plan are like a bond that backs the promise of a monthly benefit. If the employer terminates a defined benefit plan and buys an insurance contract for all promised benefits, any extra amount in the fund reverts to the employer.

Sen. Howard Metzenbaum, the AFL-CIO, and the American Association of Retired Persons (AARP) believe that asset reversions constitute fraud and that excess assets belong to workers. Business groups point out that employers would

minimize assets in pension plans if they were forced to give excess assets to workers. They also believe that employers should be allowed to keep any excess assets because they are required to make up plan investment losses if assets are not adequate to pay benefits.

The debate over excess assets has raged for more than six years now, with no end in sight. So far, Congress has been unwilling to restrict employer rights to assets once benefit promises have been satisfied.

Congress has made major changes to pension law every year, and many of these changes were designed to alter the distribution of pension benefits among sex, age, or income groups to ensure that they receive the appropriate amount of benefits and a "fair" share of the tax breaks.

There is little disagreement, however, that one part of ERISA was seriously flawed. ERISA established the Pension Benefit Guaranty Corporation (PBGC) to provide federal pension insurance. The program was designed very poorly. Troubled employers were allowed to underfund their pension plans and then dump their plan liabilities on the PBGC. Bigger and bigger plans were forced on the PBGC to the point where the agency had a $4 billion deficit in 1986. Two major changes in ERISA were required to achieve some stability in the pension insurance program. The Single Employer Pension Plan Amendments Act of 1986 and the Pension Protection Act of 1987 made pension dumping much more difficult and introduced better financial incentives into the program, such as a premium that is related to the amount of underfunding in the plan. The latest annual report of the PBGC indicates that these reforms are working.

Redistribution Rules

Because of the huge sums that are held in pension plans and the substantial tax breaks accorded to pensions, Congress has turned increasingly to pension law to achieve social objectives or to ensure that pension tax benefits are distributed "fairly." Since the mid-1980s, Congress has made major changes to pension law every year, and many of these changes were designed to alter the distribution of pension benefits among sex, age, or income groups. The basic assumption is that without a host of complex rules, low-income groups, women, and the elderly would not receive either the appropriate amount of pension benefits or a "fair" share of the tax breaks given to pensions.

Sex. Some of the recent changes in pension law were designed to increase pension benefits provided to women. The Retirement Equity Act of 1984 is the most notable example of legislation with this goal. Although career patterns for women have changed dramatically over the past 20 years, pension law was redesigned to make sure that the work patterns of the 1950s and 1960s do not deprive women of pension rights. The vesting period has been reduced in many plans from 10 to 5 years, and new rules have been established to protect pension rights during leaves of absence. In addition, pension plans must now offer a form of life insurance so that benefits are paid to the spouse if a worker dies before retirement; and spousal consent is now required before a worker can take a higher monthly benefit in lieu of continued benefits to a surviving spouse. Although these changes were supposed to increase the pension benefits of women as a class, the net effect may have been just the opposite—an increase in the number of women working in jobs where there is no pension coverage.

Age. The congressional spotlight has also turned on the pattern of pension accruals over a working career. Many pension plans were explicitly designed to encourage retention of younger workers and to encourage retirement among older workers. That practice has now become suspect as a form of age discrimination and is under heavy attack by groups that lobby on behalf of the elderly. In 1986 Congress passed new rules that require the accrual of benefits for older workers beyond the normal retirement age. In addition, a much broader attack on pensions as a workforce management tool is now moving through Congress. Following a recent Supreme Court decision (*Public Employees Retirement System of Ohio* v. *Betts*), which recognized the broad exemption in the Age Discrimination and Employment Act for employee benefit plans, Congress has sought to restrict this exemption. Mrs. Betts, who lost disability benefits when she became old enough to

qualify for a smaller pension benefit based on her few years of service, presents an extremely sympathetic case. But the legislation that has been introduced since the *Betts* decision goes much further than is required to prevent a decline in total benefits as a worker grows older.

On February 28, 1990, the Senate Labor and Human Resources Committee passed the Older Workers Benefit Protection Act (S. 1511), which restricts the coordination of pension, severance, and disability benefits. Many companies offer a package of different benefits, and the components of that package vary as the worker gets closer to retirement; younger workers who are not yet eligible for a full pension are entitled to higher severance or disability payments, and older workers are entitled to a bigger pension. These coordinated plans were designed to make sure that all workers had at least a modest level of income if they lost a job because of a plant closure or permanent disability.

The AARP has argued that parts of a benefit package should never be reduced because of age and that pension benefits should always increase with age. S. 1511 is a major step in that direction. The bill also calls into question two other important features of many pension plans: early retirement benefits and window period benefits, where employers offer increased retirement benefits to a limited class of workers for a limited period. Under the circumstances, it is easy to understand the concern that a misguided war on all age-related compensation would eliminate many of the benefit programs that have been designed to deal with job loss in a humane and equitable fashion.

Income. By far, the most complex and disruptive rules governing pension plans are the rules that are designed to assure that pension benefits are distributed fairly across income groups. These rules govern the design of the plan, contributions to the plan, and payments from the plan. To comply employers must decipher numerous and often inconsistent sections of the Internal Revenue Code and IRS regulations to answer basic questions of who is the employer, who is an employee, and what is compensation. In addition, highly compensated employees must be identified under a host of alternative definitions, involving numerous tests and several salary levels. Some of these tests require that members of the same family be treated as one employee. All of these tests require esoteric and complex distinctions with little or no economic merit: What is a separate line-of-business? What is a leased employee?

This regulatory complexity penalizes both employers and employees. Individuals must follow complex distribution, roll-over, and lump-sum averaging rules to avoid tax penalties. A tax is imposed if the payments from the pension plan begin too early, if they are too late, or if the amount received is less than the prescribed amount. In addition, the total distribution cannot be "too large," even if the plan has exceptional investment returns. These rules, which are detailed in hundreds of pages and tables, are hopelessly complex and confusing. When even the experts are confounded by pension rules, it is clear that individuals cannot adequately plan for a retirement that is not jeopardized by significant tax penalties.

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One set of rules that has raised numerous complaints covers the extent to which employers can take Social Security into account when they set benefit levels. This now-restricted practice, known as Social Security integration, makes a great deal of economic sense. Employees certainly take Social Security into account when they plan for retirement. Moreover, because Social Security replaces a higher fraction of income of low-wage workers, a desirable pension plan from both the workers' and the employers' standpoint is one that replaces a smaller fraction of the income of low-wage workers relative to better-paid workers.

But Congress views Social Security integration as discriminatory toward low-income groups and has limited the extent of integration considerably. To offer a pension to anyone, employers are sometimes forced to provide pensions to some workers that would lead to higher levels of income in retirement than during the working years. To make matters worse, the rules that define allowable integration are virtually impenetrable and constantly evolving.

Given the likely behavioral response to unwanted savings forced through the private pension system, the complex Social Security integration rules are probably costly detours at best. Economic research confirms that workers pay for pension benefits through lower wages. We also know that it is relatively easy for many workers to alter their savings and borrowing behavior in response to changes in their private pensions. What happens, then, to a low-income worker when his pension is increased because of the new Social Security integration rules? First, the take-home pay of the worker is reduced, and second, the worker reduces other savings or increases borrowing to compensate. Because of these responses, there may be little or no change in lifetime income or consumption during retirement. Thus, although the Social Security integration rules have been designed to redistribute income through the pension system, the most likely impact is an increase in costs borne by workers and costs borne by firms. Workers are forced to pay additional costs to achieve desired life-cycle patterns of consumption. The costs of obtaining a home-equity loan are, for example, more than trivial. In addition, firms pay substantial costs in redesigning and communicating new pension plans.

Unfortunately, the example of Social Security integration is not unusual. Virtually all of our pension laws have been passed under the assumption that individuals and labor markets do not adjust when new pension laws create artificial constraints. To the contrary, there is a strong belief that pension laws can be used to change the distribution of income and that tax incentives can be used to alter fundamental compensation and consumption patterns. To date, there is not a shred of evidence to support this belief, yet it remains a fundamental tenet of our national pension policy.

A New Wave of Regulations

Efforts to redistribute income through our pension system will undoubtedly continue, but there is also a new wave of pension legislation on the horizon that threatens to be equally troublesome. Now that pension plans have assets that exceed $2 trillion, pension funds have become a tempting target and a source of funds for schemes that are completely unrelated to retirement objectives.

Whenever there is an economic controversy, pension funds immediately appear on the front lines as either victims or villains or both. After the stock market crashed in October 1987, attention was quickly focused on pension funds; they were thought to have caused the crash by engaging in suspect activities such as index arbitrage, portfolio insurance, or program trading. Another widespread belief in the early aftermath of the crash was that the decline in stock values had jeopardized retirement income. Neither of these concerns turned out to be valid, but nonetheless there have been repeated calls for restrictions on pension plans to increase market stability or to improve the performance of the economy.

One example of this perspective can be found in a bill (S. 1654) introduced by Sens. Nancy Kassebaum and Robert Dole. Under this bill, known as the Excessive Churning and Speculation Act, pension plans would pay a tax on all gains from assets held less than 180 days. The bill was designed according to Sen. Kassebaum "to encourage pension funds to adopt a better long-term strategy."

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Proponents of the bill believe that corporate managers cannot make the investments that will allow the United States to compete in global markets unless they are protected from the short-sighted demands of pension-fund managers who allegedly flee from a stock whenever long-term investments are announced.

Although there is plenty of hard evidence that refutes this fable of pension myopia, the belief that we need to be protected from pension plans persists. The premise behind the Kassebaum-Dole bill received wide support at a hearing before the Senate Finance Committee in March 1990. Even Treasury Secretary Nicholas Brady applauded the goals of the bill, although he opposed the excise tax as a way to achieve those goals. Instead, Brady believes that a change in pension law is more appropriate to prevent pension funds from endangering capital formation.

Secretary Brady's position provides little comfort to professionals in the pension community.

Opposed to any change in pension law after virtually continuous legislative turmoil, pension professionals are especially leery of a change that would allow pension funds to be used for anything other than retirement security. If pension plans are used as a tool to promote investment in capital equipment and R&D, can investments in the infrastructure, the environment, or union-approved companies be far behind?

Pension funds have also been implicated in the controversy over corporate restructurings. Pension funds are viewed as unstable ballast in our economic system that careens from one set of managers to the next in a takeover battle to pursue the "quick buck." Pension funds have also been charged with fueling the junk bond market that finances takeovers. Here again, pension plans are not only villains, but victims. Many pension plans have excess assets, and these plans are seen as irresistible to corporate raiders when they hunt for takeover targets.

Congressional hearings revealed that LBOs were not driven by pension funds and that pension funds gained from investments in LBOs and other restructuring activities, but the belief that something needs to be done persists.

Eight separate committees of Congress held 21 days of hearings on leveraged buyouts (LBOs) in 1989. These hearings revealed that LBOs were not driven by pension funds and that pension funds gained from investments in LBOs and from other restructuring activities. But even though the facts exonerated pension funds, the belief that something needs to be done persists.

Shortly after the LBO hearings, Congressman Peter Visclosky introduced legislation that would force a major change in the way pension plan investment decisions are made to address "concerns over the pernicious effect of leveraged buyouts." The Visclosky bill would create an equal number of worker and management trustees for all pension plans and consequently, an administrative quagmire that could ensnarl the management of funds that own nearly one-fourth of all corporate equities and 40 percent of corporate bonds.

Antitakeover pension legislation has also been introduced in the Senate. Three Democratic senators recently introduced an amended version of antitakeover legislation that has been pending for several years. The bill (S. 2160) would prohibit the use of surplus pension assets to finance a takeover, either directly or indirectly. In addition, the bill would amend ERISA to prohibit a plan from earning more than 30 percent of its income from shares held less than three months. One of the ironies of the 30-percent rule is that it is likely to increase rather than decrease the turnover of stock in pension funds. The rule already applies to mutual funds. When a mutual fund experiences large short-term gains that violate the 30-percent rule, it sells shares that have been held more than three months to increase the proportion of measured (realized) income from "long-term" investments.

These bills are only a few examples of the new wave of pension legislation that is bound to continue. Congress will turn to pension plans to find a cure for many problems, both imagined and real, because, as Willie Sutton said when asked why he robbed banks, "That's where the money is." Moreover, it is much easier and safer for Congress to blame pension plans for economic problems than it is to reexamine tax and spending policies that are more likely to be the real culprits.

Effects of Pension Regulation

Constant change in our pension law means that employers must frequently amend pension plans and communicate these changes to employees. Although the promise of a pension should be a stable, long-term contract between an employer and a worker, in the current environment it is very difficult for either side to rely on or even understand the terms of the contract.

The regulatory complexity that results from constant change also makes it very difficult if not impossible to demonstrate compliance with the law. Substantial resources are consumed in the compliance process that could be devoted to retirement benefits for employees.

Often, major pieces of pension legislation have been passed as a part of huge budget bills. Pension provisions are added to budget bills because they raise revenue by restricting contributions to pension plans. Frequently, no hearings are held on the proposed changes, and the negative effects of the new laws are rarely explored before passage.

The result of this process, which is driven by revenue needs rather than a sound retirement policy, is described by the Association of Private Pension and Welfare Plans, a trade association that supports employee benefit plans: "[T]here has been no concern for simplicity, nor has there been an attempt to create a logical structure to the law. Often, new legislative proposals fail to recognize prior provisions addressing the same issue, resulting in an incomprehensible array of irrational rules. As a result of this failure to consider overall structure, efforts to strengthen the laws have simply led to a patchwork of overlapping, duplicative, or inconsistent provisions creating an environment in which compliance is nearly impossible and in which penalties for failure to comply with all the rules are substantial."

Defined benefit plans have been particularly hard hit by recent legislation. While many defined contribution plans are little more than tax-deferred savings accounts, a defined benefit plan is a complex contract that usually offers higher, more predictable benefits. The employer bears the investment risk, and because the benefit is paid as an annuity, the worker is also relieved of the worry that the pension will not last until he dies. It is much easier to plan for retirement when one's company offers a defined benefit plan.

In theory, the defined benefit plan also offers unique advantages to employers, primarily the ability to encourage workers to stay or to encourage them to leave. Until 1974, an unfunded (pay-as-you-go) defined benefit plan could also be used to give workers a strong incentive to make sure that the firm is profitable—much like an employee stock ownership plan.

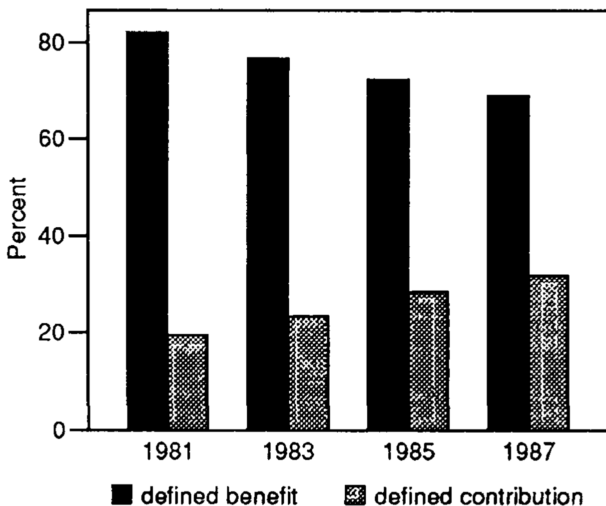
But the advantages of defined benefits to the employer have been eroded by recent legislation. Rules that cover vesting for young workers and accrual for older workers have been changed to reduce sharply the utility of a defined benefit plan as a workforce-management tool. Federal pension insurance as well as new minimum funding standards that have been adopted to protect the insurance program mean that unfunded benefits can no longer be used to induce higher productivity. In addition to these changes, the maximum amount that an employer can put in a defined pension plan has also been reduced. These changes reduced employer flexibility with respect to annual contributions and reduced the tax advantages of defined benefit plans for employers who were funding at the old maximum limits.

Defined benefit plans have been particularly hard hit by recent legislation. A defined benefit plan is a complex contract that usually offers higher, more predictable benefits than a defined contribution plan.

All these changes have reduced the attractiveness of defined benefit plans to employers. Statistics on the type of plan offered to employees reflect this effect (see Figure 1). In 1980 the primary pension plan for 83 percent of workers with a pension was a defined benefit plan. By 1987 that figure had dropped to 68 percent. While the number of unduplicated active primary pension plan participants rose from 35.9 million to 41.9 million over this period, the number covered by defined contribution plans increased from 6.2 million to 13.4 million so that the number covered by defined benefit plans did not increase.

Some of this decline in defined benefit plans can be explained by shifts in employment patterns away from the manufacturing industries that typically offer defined benefit plans. But

Figure 1: Primary Plan Coverage: Defined Benefit vs. Defined Contribution (percentage of participants)



Source: Pension Benefit Guarantee Corporation's *Annual Report* (1989).

much of this change is attributable to a decline in the probability that any given employer will adopt or continue a defined benefit plan. The decline in defined benefit plans is particularly apparent among small employers, and this pattern implicates regulatory overload as one of the causes of the decline. The costs of the new regulations, particularly the cost of achieving and proving compliance, are relatively fixed and consequently put a heavier burden on smaller plans.

Many pension experts believe that the decline in defined benefit plans is not consistent with sound national retirement policy. Defined benefit plans offer at least two distinct advantages in providing retirement security. First, the assets in defined benefit plans yield higher rates of return than the assets in defined contribution plans, because investments in defined contribution plans are often directed by workers, who have lower tolerances for risk than firms. The Employee Benefit Research Institute reports that the annual real rate of return over the past five years for defined benefit plans has been nearly two percentage points greater than the rate of return for defined contribution plans. Second, defined contribution benefits are also distributed as lump sums, which makes retirement planning more costly and difficult because reserves must be set aside to cover the contingency that the worker will live an unusually long time. These reserves are unnecessary for most recipients of defined benefit pensions because benefits are usually paid out as annuities. And, most important, the investment risk of providing an expected pattern of benefits is borne by the employer, not the individual worker.

Defined benefit plans are not better for everybody; young mobile workers often prefer defined contribution plans. But the choice of pension plans should be made on the basis of what is best suited to the interests of firms and workers; it should not be determined by taxes or regulatory burdens. Moreover, we cannot assume that employers will continue to bear the added risks associated with defined benefit plans if they are denied any of the advantages. Many of the legislative reforms of the past few years can be characterized as an attempt to give workers the advantages of defined benefit plans without the mobility constraints and other features that make these plans attractive to employers. The decline in defined benefit plans is one indication that there is a significant cost that has been imposed by regulatory and legislative turmoil. Some workers no longer have the opportunity to earn a generous and secure defined benefit pension.

Many pension experts believe that the decline in defined benefit plans is inconsistent with sound national retirement policy. While defined benefit plans are not better for everyone, the choice of pension plans should be made by what is best suited to the interests of firms and workers. It should not be determined by taxes and regulatory burdens.

Conclusion

Our private pension system is being battered by continuous change in our pension laws and a stream of complex and contradictory regulations. Part of the problem is that the pension system is being used in a vain attempt to redistribute income and to achieve other political objectives. Another problem is that we have no structure for evaluating the cost and benefits of increased pen-

sion regulation. Too often it appears that the goal of restrictions on our pension system is to prevent any opportunity for perceived abuse, with no weight given to the cost of these restrictions imposed on employers and recipients of pension benefits. In fact, our current budget accounting measures the impact of increased regulations as an increase in tax revenues that results from lower contributions to pension plans. How can we not have too much regulation if we use this framework?

We need to reexamine our goals to determine whether they can and should be achieved through our private pension system. It is time to stop pruning the trees and look at the forest. If we do not, our nation's population may grow older without adequate resources to meet our retirement needs.

Selected Readings

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