Why We Retired Our Pensions, and How to Revive Them

By Kerry Pechter *Wed, Jan 5, 2011*

An ambitious new book, The Decline of the Traditional Pension, captures the state of public, private, domestic and global pensions with scholarly rigor.

The atrophy of the defined benefit pension system in the U.S. isn't news, but *The Decline of the Traditional Pension* (Cambridge, 2011), a fine new book, takes a fresh look at the sources of the problem, suggests some remedies, and compares our system with those in other countries.

The author, George A. "Sandy" Mackenzie, is a 1972 Rhodes Scholar who spent over a quarter-century at the International Monetary Fund before joining AARP's Public Policy Institute in 2008. He has also written *Annuity Markets and Pension Reform* (Cambridge, 2006).

This week, Mackenzie discussed *The Decline of the Traditional Pension* (now available at Amazon.com and Barnes & Noble) with *Retirement Income Journal*.

RIJ. In your description of the decline of the traditional pension in the U.S., it sounds like you'd like to see it return in some form.

Mackenzie. The book basically says that a pension in the form of an annuity is a valuable thing. I have regretfully come to the conclusion that the traditional pension cannot ever recover its former position. But I believe that substitutes for the traditional pension, or changes to other pension forms that will endow them with the desirable aspects of the traditional pension, are called for.

RIJ. Was there ever really a "golden age" of pensions in the U.S.?

Mackenzie. There's a certain nostalgia about traditional pensions that overlooks the fact that not everyone, even 20 or 30 years ago, was a lifetime employee at a firm. The traditional pension wasn't without its faults, particularly in this country.

RIJ. Faults?

Mackenzie. For instance, in a country like the U.S. with high average turnover of labor, a vesting period of five years means people can accumulate no pension rights in their lifetime. Even if they do, these rights are typically not adjusted for inflation. Once upon a time there were no legal restrictions on vesting periods, and they reflected the relative bargaining power of unions and employers. The pension was used as a motivational device for encouraging long service, and a high minimum vesting period accomplishes that. But if you view the pension as a necessary 'second tier' of retirement security [after Social Security], a high vesting period means security will be distributed unequally.

RIJ. You say that five years is too long a vesting period—but didn't the 1974 ERISA law shorten the vesting period to five years, and didn't that change promote the decline of traditional pensions?

Mackenzie. In the U.S., ERISA imposed a vesting period of five years for 'cliff' vesting and seven years for gradual vesting. That seems to have had a substantial impact. It increased costs. That might not have been a big deal if employers were able to change a pension plan's other parameters easily. But if there's limited flexibility, the employer can say, this can increase my costs, with predictable results.

RIJ. Has the Fed's low interest rate policy hurt traditional pensions?

Mackenzie. Low interest rates haven't helped. But keep in mind that they have a similar effect on a defined contribution plan as they do on a defined benefit plan. In a DC plan, individual participants are acting as one-person pension funds, and they should think in the same way: 'I should be saving more, because the 401(k) plan won't give me the same replacement rate that it would have five years ago.'

RIJ. You've looked at what other countries are doing with their pension systems. What reforms overseas do you think might work here?

Mackenzie. Switzerland has a hybrid second-tier program that offers a minimum rate of return during the accumulation phase, and an upper limit on the annuity premium at retirement, so that you know what you'll get at retirement. It's built into the system. Something like this is ideal. But the attractive features of programs overseas come either at the cost of greater government involvement or in the presence of a different labor environment than in the U.S. The impact of unions is much greater overseas. In the Netherlands, broad pension coverage is built into labor contracts. In Australia, where the labor market is more like ours, the government requires a DC scheme like a 401(k). The funds themselves are private and can be run by large employers or by the financial industry, but the government stipulates coverage and contribution rates.

RIJ. You seem to like the relatively new in-service annuity concept, where participants purchase a little piece of future income with each of their 401(k) contributions. Why does that appeal to you?

Mackenzie. The in-service annuity is a way of combining the annuity feature of a DB plan with a 401(k)-type plan. But everything depends on how efficiently it's done. If the annuity isn't actuarially fair, it's not a good deal. But if it's done efficiently, it's a good deal. The book poses but doesn't answer the question that, if somebody saves in such a plan for 30 years and the plan pays out for another 30 years of retirement, how do you finance that? But the gradual annuitization aspect is a good idea. People are scared of plunking down a huge lump sum for an annuity. The in-service annuity idea has great potential.

RIJ. Do you recommend personal annuities for people without traditional pensions?

Mackenzie. It used to be true, and may still be true, that $100,000 was the expected premium for a life annuity. For most Americans, even a $50,000 premium would represent a high percentage of their savings. So I'm not certain that a life annuity is appropriate for most Americans. It might be more of a middle or upper middle class phenomenon. The 401(k) system covers a lot of Americans, and if you've got $600,000 or $700,000 in a 401(k), then paying $200,000 for a life annuity makes sense. There are still problems with excessive cost and adverse selection. The solution might be government intervention to dictate the conversion factor, as in Switzerland, but I don't think that will happen in the U.S.

RIJ. What discouraging signs or trends, economic or political, do you see?

Mackenzie. Let me try to answer in more positive terms. Part of the issue is that people will have to save more over time. The basic ingredient to a secure retirement is higher savings and that's difficult to do. Another challenge will be making people better informed and educated financially. That won't be easy. Financial education is technical in nature and people will have to change habits. You can have a decent knowledge of nutrition but that doesn't mean you can change your diet or lose weight. There are simply a lot of demands on Americans' resources at the moment, so not much is left over for savings.

RIJ. What hopeful signs or trends, economical or political, do you see?

Mackenzie. Winston Churchill said that Americans always do the right thing after exhausting the alternatives. I do believe that more Americans will be covered by some sort of savings or pension plan in the future. It won't necessarily be the high-coverage system of Australia or Netherlands or Denmark but I do think things will improve. Making any headway in the current environment will be difficult. It's hard to advance reforms in a climate of austerity.

RIJ. If you were in charge of California's public employees pension, CalPERS, what would you do to save it?

Mackenzie. I would propose some combination of increases in contributions and reductions in benefits, while doing it in a way that protects the most vulnerable.

RIJ. Thank you, Mr. Mackenzie.