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SUBMISSION FOR THE RECORD

of the

SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

HEARING ON

S.1066

held on

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From

Dallas L. Salisbury*

The views expressed in this statement are those of the author and do not necessarily reflect the views of the Empliyee Benefit Research Institute, its Trustees, its members, or other staff.

EMPLOYEE BENEFIT RESEARCH INSTITUTE
2121 K Street, NW Suite 860 Washington, DC 20037 Telephone (202) 659-0670

INTRODUCTION

This nation has had a longstanding commitment to providing economic security for the aged. This commitment is most broadly emphasized by Social Security -- OASI, DI and HI. Employer sponsored pension programs and government incentives for their creation and maintenance are the second component.

- o Social Security benefit indexation has helped achieve economic security -- at a cost.
- o Employer pensions have been criticized vis-a-vis Social Security because they do not generally index benefits.

The 1963 Report of the Kennedy Commission on Pension Policy and the 1980 Report of the Carter Commission identified the absence of indexation as the critical shortcoming of employer sponsored pensions. Recent books published by the American Enterprise Institute and The Brookings Institution have emphasized this same point.

The debate raises two issues:

1. Should the indexation of employer pensions be mandated?
2. Should the indexation of employer pensions be facilitated?

From EBRI's review of studies and reports of the past, two conclusions are prominent.

1. Indexation should not be mandated for reasons of both employer cost and federal revenue loss.
2. Indexation should be encouraged to the degree that employers and employees make the judgment that they wish to afford it.

This bill under consideration today, S.1066, would facilitate the indexation of employer pension benefits on a cost shared basis. Attachment 1 presents a summary of the proposal and selected questions and answers.

Are Employer Pensions Indexed?

The Federal government does provide for full indexation of retiree benefits under the programs it sponsors (Civil Service Retirement, Military Retirment, etc.). A majority of state and local Governments provide for full indexation as well.

Private employers have not generally provided automatic indexation in the past. For the approximately 6 percent of employers who do automatically index it is not full indexation. Most frequently the adjustment is limited (capped) to 3 percent or 4 percent of pay.

Many additional employers provide ad hoc increases. One recent survey indicates that between 1978 and 1982 over two-thirds of large employers provided some postretirement cost of living adjustments. Tables from this survey by Hewitt Associates are appended as Attachement 2. This data is consistent with studies by the Bankers Trust Company of New York.

More and more employers are facilitating indexation by providing a retirement benefit option that includes a 3 percent (or higher) annual adjustment in return for lower intitial benefits. S.1066 proposes to allow such adjustments on a fully pre-funded basis without a reduction in the promised defined benefit.

Would S.1066 be Consistent with Current Public Policy?

It is the Institute's assessment that S.1066 would be consistent with current public policy. S.1066 would authorize a new approach to doing what public policy already encourages -- postretiremenet indexation. Using other methods than those proposed by S.1066, indexation is already allowed by law on a tax favored basis (taxes are deferred on the contribution cost until benefits are actually paid).

<u>Would S.1066 Lead to Federal Revenue Deferrals?</u>

Employers have the ability under current law to expend up to 15 percent of total cash compensation costs on retirement income programs. The nations largest employers are currently expending approximately 13 percent, and other employers less. Therefore the law already allows for additional federal revenue deferrals as aging of the workforce and a growing retiree population push expenditures higher.

To the degree that passage of S.1066 created a delay in consumption that would have otherwise taken place at normal retirement age the federal tax deferral would increase.

To the degree that S.1066 created substitution behavior -- meaning that the employer would provide the increase over time instead of funding them fully in the initial year -- there would be no change in federal revenues.

Based upon current indexation trends a realistic revenue deferral figure can be calculated.

Total Annual Defined Benefit Contributions	$ 40 billion
Times Cost of 17 Year 2% Index	17 percent
Cost of Index if all Plans Indexed	$6.8 billion
Times IRS Marginal Tax Rate Assumption*	12 percent
Revenue Deferral if all Plans Indexed	$ .816 billion
Revenue Deferral if 25% Indexed	$ .208 billion

Under the calculation approach for "tax expenditures" used by the Treasury Department the ultimate tax expenditure would be significantly lower than this tax deferral amount of 208 ~~b~~million dollars. Because some level of

*12 percent is used since the payment is made at the time of retirement.

substitution for postretirement increases that would have otherwise taken place is represented here, and because fewer than 25 percent of plans would probably use the S.1066 method.

Would S.1066 Improve Economic Security of the Retired?

It is undeniable that a postretirement pension increase will improve economic wellbeing. An automatic index provides certainty for the retiree. A capped automatic index provides cost control at the same time for the employer and an absolute limit on potential federal revenue deferrals.

These advantages of the S.1066 approach are not attributable to current federal retirement programs. This fact, among others, has caused some of the Social Security financing problem. Should high inflation return, the government's flexibility would likely be enhanced by greater indexation of private employer pensions.

Should the Congress Pass S.1066?

Only the Congress can make this decision. The Institute's analysis has concluded that:

1. Over two-thirds of employers now provide some form of indexation and that S.1066 would provide one means of regularizing such increases.

2. S.1066 would be consistent with current public policy which encourages idexation.

3. S.1066 would likely cause limited federal revenue deferrals beyond current practice and none beyond what is possible under current law.

4. S.1066 could improve economic security for those retired individuals receiving postretirement increases as a result of its passage.

5. Greater indexation of employer pensions could increase long term government flexibility with regard to Social Security and other income transfer programs.

SUPPLEMENTAL RETIREMENT BENEFIT TAX LEGISLATION

Background

Retirees today are facing many uncertainties with respect to the future earning power of their private pensions -- at the same time pressures on the Social Security system continue to grow. As a result, companies and concerned employees are taking a closer look at how they can be assured of a more sound financial future beyond their working years.

Supplemental Retirement Benefits (SRB's)

One innovative approach to the problem of maintaining the value of private pensions is to provide supplemental retirement benefits in the form of insured annuities or investment contracts -- jointly funded at retirement by employees and their companies -- which index other company-provided retirement benefits. Such supplemental retirement benefits could go a long way toward meeting rising costs during retirement and encouraging savings during an employee's working years. Such an approach also permits employers to establish a coherent program of retirement income protection.

SRB Legislation

Proposed SRB legislation would allow employees to elect, at or after retirement, to dedicate a portion of their tax qualified defined contribution plan (i.e., profit sharing and certain other types of plans) accounts, or other funds, to be matched by employer contributions, toward purchase of a "supplemental retirement benefit" in the form of an insured annuity. The annuity would provide an additional benefit equal to a percentage of a retiree's pension and would compound each year in value. More specifically, the bill, which amends the Tax Code:

- permits employers to make the necessary contributions for the purchase of supplemental retirement benefits at, or after, retirement; and,

- permits employees to incur no tax liability until amounts are distributed under the annuity.

Supplemental retirement benefits would be subject to the safeguards built into the Internal Revenue Code and ERISA as they apply to defined contribution plans. No attempt would be made to amend Title I of ERISA.

QUESTIONS AND ANSWERS REGARDING SUPPLEMENTAL RETIREMENT BENEFITS

QUESTION:

Why is a Supplemental Retirement Benefit Program ("SRB") important?

ANSWER:

Recent sustained periods of double-digit inflation have eroded benefits accrued by retirees during their careers. A supplemental retirement benefit is intended to preserve the relative buying power of pension payments.

QUESTION:

Why don't employers simply increase benefits payable under their defined benefit pension plan?

ANSWER:

Most companies' defined benefit plans (i.e., a plan which promises a specific benefit at retirement, such as $100 per month) calculate the benefits payable to an employee at retirement as a percentage of final or final average earnings. Provided an employer's salaries keep pace with inflation, the initial pension is generally adequate to meet a retiree's needs. However, once the pension is payable, its purchasing power can be rapidly eroded by even a modest rate of inflation, let alone that of recent history. To simply raise the benefits payable at retirement in anticipation of cost-of-living increases or to index defined benefit pensions to inflation is itself inflationary and too expensive for most employers.

QUESTION:

How have employers dealt with inflation on fixed retirement income in the past?

ANSWER:

Most large employers coped with this problem by increasing the pensions payable to retirees (as opposed to those who were entitled to vested terminated benefits) through "ad hoc" adjustments, payable out of general corporate assets. Traditionally, these "ad hoc" payments had to be renewed on a year-to-year basis and were increasingly expensive and administratively burdensome. From a retiree's viewpoint, ad hoc payments were also unsatisfactory since, given the contingent nature of the payment, the retiree could not rely on either the increments granted to his pension in previous years or the employer's decision to increase his or her pension in response to current inflation.

QUESTION:

In spite of these drawbacks, why can't employers continue to increase basic pensions using ad hoc payments?

ANSWER:

The Employee Retirement Income Security Act of 1974 ("ERISA") requires essentially that these gratuitous ad hoc payments be treated as retirement payments which must be funded prior to retirement through a tax-qualified retirement plan and must be subject to vesting requirements applicable to pension or retirement plans. In 1980 Congress amended ERISA to allow for nonretirement supplemental payments. However, neither the statute nor the proposed supplemental payment regulations issued by the Department of Labor permit a sustained annuity purchase program comparable to the SRB proposal.

QUESTION:

How does an SRB program work?

ANSWER:

A participant in both a defined benefit pension plan and a defined contribution plan (i.e., a plan which provides a retirement benefit equal to amounts contributed to a participant's account, plus earnings) maintained by the same employer will be allowed to elect to dedicate a portion of his account balance in the defined contribution plan (or from other sources, including personal savings) toward the purchase of an insured annuity. The cost of the annuity will be shared through a matching employer contribution made to the plan at the time of the participant's election. The annuity will provide an escalating percentage increase in the pension payable under his employer's defined benefit pension plan.

QUESTION:

What are the advantages to an employee of providing an SRB through a tax-qualified retirement plan?

ANSWER:

Employer annuities purchased outside a tax-qualified plan on behalf of an employee result in immediate taxation, to the employee, equal to the cash value of the annuity. In contrast, an employer may contribute to the purchase of a nontransferable annuity on behalf of a participant in a tax-qualified plan without causing the participant to recognize tax on the distribution until he begins to receive payments under the annuity, and then only to the extent of employer-derived amounts actually received in a given tax year. Finally, the use of a tax-qualified plan as a vehicle to provide supplemental retirement benefits assures employees that the benefits will be distributed equitably and that past and current increases in pension benefits will be continued.

QUESTION:
Why can't a supplemental retirement benefit be provided under current law?

ANSWER:
The overall limitations on amounts allocated to a participant's account is limited to 25% of compensation, up to a maximum dollar amount. Since the cost of purchasing an SRB annuity is high (ranging from approximately 70% to 120% of final pay), employer contributions to fund an SRB will in most cases exceed the current applicable limits.

QUESTION:
How is the employee who purchased an SRB annuity protected?

ANSWER:
By requiring that the SRB be provided through an annuity purchased from a licensed insurance carrier and by further requiring that the annuity be fully funded prior to the commencement of supplemental benefits, the risk that the benefit will not be provided is practically nonexistent. It is also conceivable that part of the employer portion of the SRB could also be provided through a defined benefit plan in conjunction with an insured benefit under a defined contribution plan (e.g., a 10-year guaranteed investment contract under the defined contribution plan with the remaining supplemental retirement benefits payable for the remainder of the retiree's life from the defined benefit plan). However, since the defined benefit portion would be subject to existing funding requirements and guarantees by PBGC, employees who participate in such a program will be fully protected.

QUESTION:
May the SRB annuity be provided through a profit sharing plan?

ANSWER:
Yes. Many employers use profit sharing plans to supplement defined benefit plan benefits since the costs of such plans can be more easily controlled. Often, to encourage employee savings, such plans provide for employee contributions which are then matched by employer contributions. Under present law, employer contributions to profit sharing plans must be contingent upon the

existence of profits. Under the proposed legislation, an employer's contribution to purchase an SRB annuity could likewise be made contingent on profits; however, the legislation specifically provides that if the employer fails to make its contribution for any reason, the employee's contribution is to be returned at the employee's request. It should be reemphasized that once the annuity is purchased the SRB is guaranteed.

QUESTION:

May the SRB benefit be limited to employees who retire from service with the employer maintaining the SRB benefit, as opposed to employees who terminate service with an employer prior to retirement with a vested benefit ("terminated vested employees").

ANSWER:

Yes. Present law does not require an employer to provide the same benefits to both retirees and terminated vested participants, so long as the benefits are provided to a fair cross-section of employees. At the same time, employers have traditionally limited supplemental payments to retirees as both an incentive and a reward for faithful, long-term service.

Attachment 2

POSTRETIREMENT PENSION INCREASES

Many major U.S. employers granted postretirement pension increases in the late 1970s and early 1980s. Little data has been available regarding widespread company practices on postretirement pension increases granted in 1982 or anticipated for 1983. [Only companies with a defined benefit pension plan were asked to respond to this survey issue.]

Survey Question	Overall Total	Banks	Manufacturing Companies With Annual Sales of: $100 to $499.9 Mil	$500 to $999.9 Mil	$1 to $2.49 Bil	$2.5 Bil and Over
1. Has your company granted a postretirement pension increase to salaried employees during the period 1978-1982?	(283 cos.)	(53 banks)	(71 cos.)	(48 cos.)	(53 cos.)	(58 cos.)
• Yes	66%	81%	45%	63%	64%	81%
• No	34%	19%	55%	37%	36%	19%
If yes, in what years were increases granted? (multiple responses possible)	(186 cos.)	(43 banks)	(32 cos.)	(30 cos.)	(34 cos.)	(47 cos.)
• In 1978	27%	32%	9%	23%	20%	--
• In 1979	38%	37%	37%	33%	47%	34%
• In 1980	43%	56%	28%	47%	29%	51%
• In 1981	32%	37%	25%	30%	23%	38%
• In 1982	20%	23%	28%	7%	18%	23%

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POSTRETIREMENT PENSION INCREASES (Continued)

Survey Question	Overall Total	Banks	Manufacturing Companies With Annual Sales of: $100 to $499.9 Mil	$500 to $999.9 Mil	$1 to $2.49 Bil	$2.5 Bil and Over
1. (Continued)						
If yes, how many increases have been granted during 1978-1982?	(186 cos.)	(43 banks)	(32 cos.)	(30 cos.)	(34 cos.)	(47 cos.)
• 1 increase	60%	63%	72%	70%	65%	40%
• 2 increases	30%	19%	28%	23%	32%	42%
• 3 increases	4%	2%	--	3%	2%	9%
• 4 increases	2%	2%	--	3%	--	4%
• 5 increases	4%	14%	--	--	--	4%
2. Will your company grant a postretirement increase in 1983?	(283 cos.)	(53 banks)	(71 cos.)	(48 cos.)	(53 cos.)	(58 cos.)
• Definitely yes	4%	8%	1%	--	4%	5%
• Probably yes	2%	4%	1%	2%	2%	2%
• No	73%	60%	85%	75%	77%	66%
• Not yet determined	21%	28%	13%	23%	17%	28%

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Survey Question	Overall Total	Banks	Manufacturing Companies With Annual Sales of: $100 to $499.9 Mil	$500 to $999.9 Mil	$1 to $2.49 Bil	$2.5 Bil and Over
3. If you did not grant an increase in 1982 nor plan to grant one in 1983, what is the primary reason for not granting an increase?	(154 cos.)	(23 banks)	(32 cos.)	(32 cos.)	(34 cos.)	(33 cos.)
• Lower rate of inflation	22%	22%	19%	15%	21%	33%
• Company's financial situation	33%	17%	25%	41%	44%	30%
• Little pressure from retirees	5%	13%	6%	--	5%	3%
• No pattern-setting precedent	18%	26%	22%	15%	15%	15%
• Other	22%	22%	28%	28%	15%	18%

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POSTRETIREMENT PENSION INCREASES (Continued)

Additional Observations

- Thirty-four companies (22%) mentioned "other" reasons for not granting an increase in 1982 or 1983. Those reasons include:

    - the increase in benefit costs (7)
    - a belief that Social Security increases have been adequate in keeping retirees' income whole with inflation (5)
    - a favorable pension formula which makes present benefits adequate (5)
    - a company philosophy against granting pension increases (5)
    - a more critical need to improve benefits for active employees (4)
    - the last increase was granted within the last few years (3)