Policy Note: THE TROUBLE WITH PENSIONS: Toward an Alternative Public Policy to Support Retirement

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No one needs to be reminded that pension funds have taken a big hit over the course of this crisis. Private pensions are now just over 80% funded, meaning that the value of accumulated assets falls short of meeting promised pay-outs of defined benefit pension plans by about a fifth, amounting to a $400 billion shortfall. Public pensions provided by state and local governments have a shortfall estimated to run as high as $2 trillion. On any reasonable accounting standard, the PBGC is troubled because its reserves will be wiped out by the failure of just a couple of large firms on “legacy” pensions. There has been a long-term trend to convert defined benefit plans to defined contribution plans—which means that workers and retirees take all the risks. Indeed, this is often the outcome for “legacy” defined benefit plans that require bail-outs. In spite of some attempts to improve management and transparency of pension funds, it likely that the PBGC, itself, will need a government bail-out, and that retirees face a more difficult future.

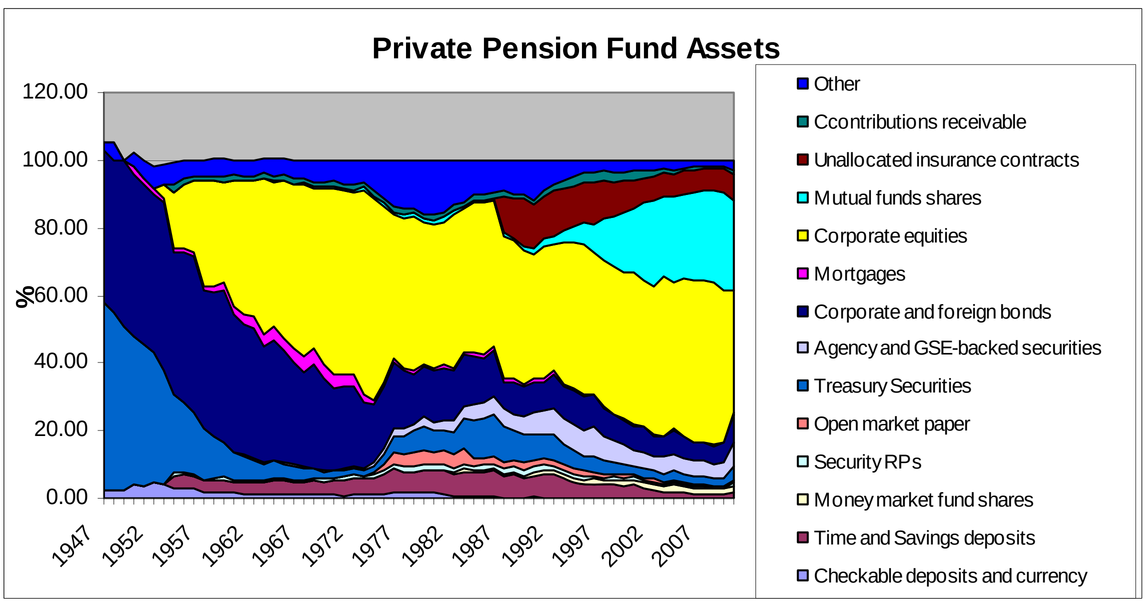
In this Policy Note we will briefly examine how we got into this mess—and how deep the hole is. More importantly, we will argue that the current approach to managing pension funds leads to excessive cost and risk—both for covered individuals but also for the society as a whole. We advocate a different approach that would rely more heavily on government support for retirement through expansion of Social Security.

I. HOW DID WE GET INTO THIS MESS?

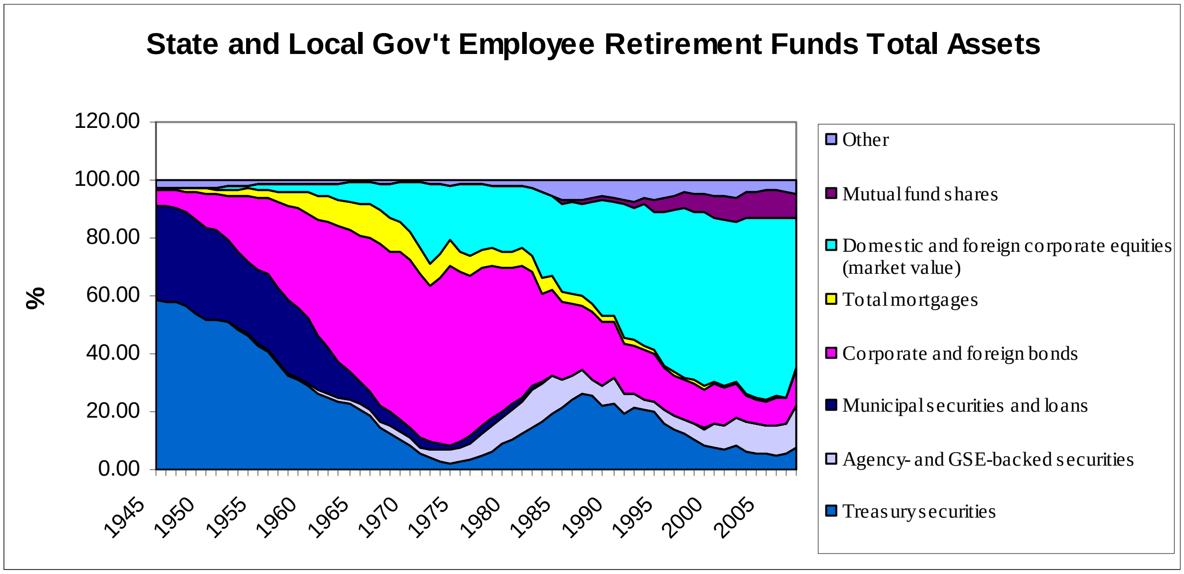
It is important to understand how we got into this predicament. During WWII government wanted to hold down wages to prevent inflation, given that much of the nation’s productive activity was oriented toward the war. Unions and employers negotiated postponed payment in the form of pensions—which pleased all three parties: big firms, big government, and big unions. Unions got to deliver decent retirement income to members—a useful recruiting tool. Government promoted this with tax advantages for contributions to pensions, and by pushing spending into the post-war years it reduced inflationary pressure. And firms loved pushing costs to an indefinite future—rather than paying wages, they would promise to pay pensions 30 or 40 years down the road. Much of the promise was unfunded, or met by stock in the firm. This meant that pensions could be paid only if the firm was successful for a very long time into the future. In those heady days of domination of industry by powerful American oligopolists that seemed to be a fairly safe bet. That was the era of John Kenneth Galbraith’s New Industrial State, after all, when it appeared that the coalition of government, business, and labor interests could ensure preservation of market share, and the power to set wages and to set prices at a level to cover wages and benefits such as pensions.

Unfortunately, that did not last as long as many thought it would. Competition (especially foreign) chipped away at market power, while bankruptcies, downsizing, and mergers and acquisitions endangered the ability to meet pension liabilities. As time went on and it became apparent that "legacy" firms might not survive for the necessary half century (or more), unions and government felt that a mere promise to pay pensions would not suffice. Either firms would have to kick in a huge amount of cash to fully fund the pensions, or government would have to guarantee the pensions. Corporations did not like the costs attached to full funding. The grand compromise was that firms would increase funding a bit, and government would provide insurance through the PBGC. Effectively, Uncle Sam was going to be on the hook for any underfunding. Funding did increase, although the more frequent and more severe crises in the post 1970 period always wiped out enough assets in each crash to cause pension funding to dip below prudent levels. Only a financial bubble could get them back to full funding. To make matters worse, firms were allowed to reduce contributions during speculative bubbles (since asset values would be rising)—ensuring that the funds would face a crisis whenever the economy was not bubbling.

To reduce risk, pension funds diversified. Obviously, the riskiest portfolio would be one that was invested in the employer—effectively doubling down the bet that the firm would not face financial difficulties. Hence, a move to diversify was underway. In the early postwar period, safe Treasuries comprised a huge portion of private pension plan portfolios, as shown in Figure 1:

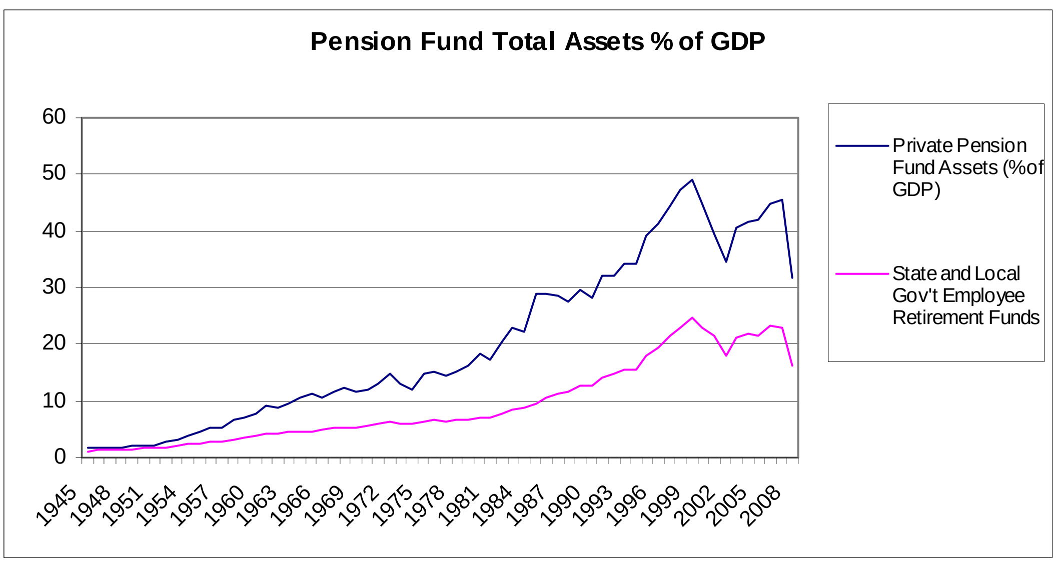


In the first years after the war, private pensions held nearly 60% of their assets in treasuries and almost all the rest in corporate and foreign bonds (bonds are always considered safer than stocks right, maybe also note that these were also sold off). However, treasuries were sold off and replaced largely with equities over the course of the 1960s. In recent years, equities plus mutual funds (indirect ownership of equities) amounted for the vast majority of holdings. Figure 2 shows the allocation of public pension funds:

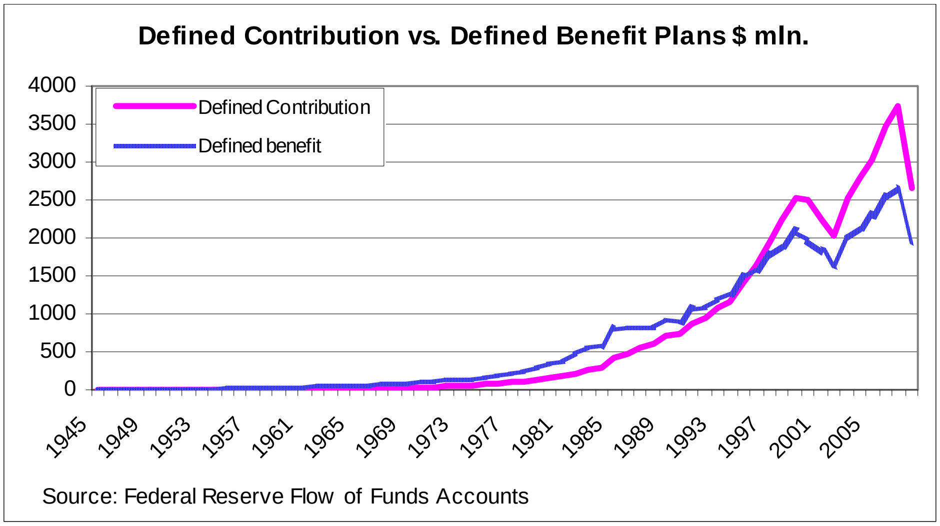


Here the story is slightly different—it took them longer to divest themselves of treasuries (although the share allocated to treasuries increased again to a peak of 20% around 1990), and they were slower to move into equities. Still, at the recent peak, equities and mutual funds accounted for about two-thirds of assets even among public pensions.

The total volumes of pension funds are huge relative to the size of the economy (and relative to the size of financial assets). Figure 3 shows private and public pension funds relative to GDP:



Together, they have climbed to about 70% of GDP. As alluded to above, there has been a trend toward replacing defined benefits with defined contributions, as shown in Figure 4: {YEVA CHECK—THIS MUST BE TRILLIONS NOT BILLIONS}



Those last two figures give some idea of the recent problems faced by pensions: the recent decline of asset values both in absolute terms as well as relative to GDP have been historically large. Private plans lost about $1.8 trillion on their financial assets between 2007 and 2008, with equities and mutual fund shares losing $1.4 trillion. As a share of GDP, private pensions fell by nearly fourteen percentage points between 2007 and 2008. Public plans fell by about nine percentage points of GDP.

{INSERT FUNDING RATIOS HERE}

{INSERT PBGC DATA HERE}

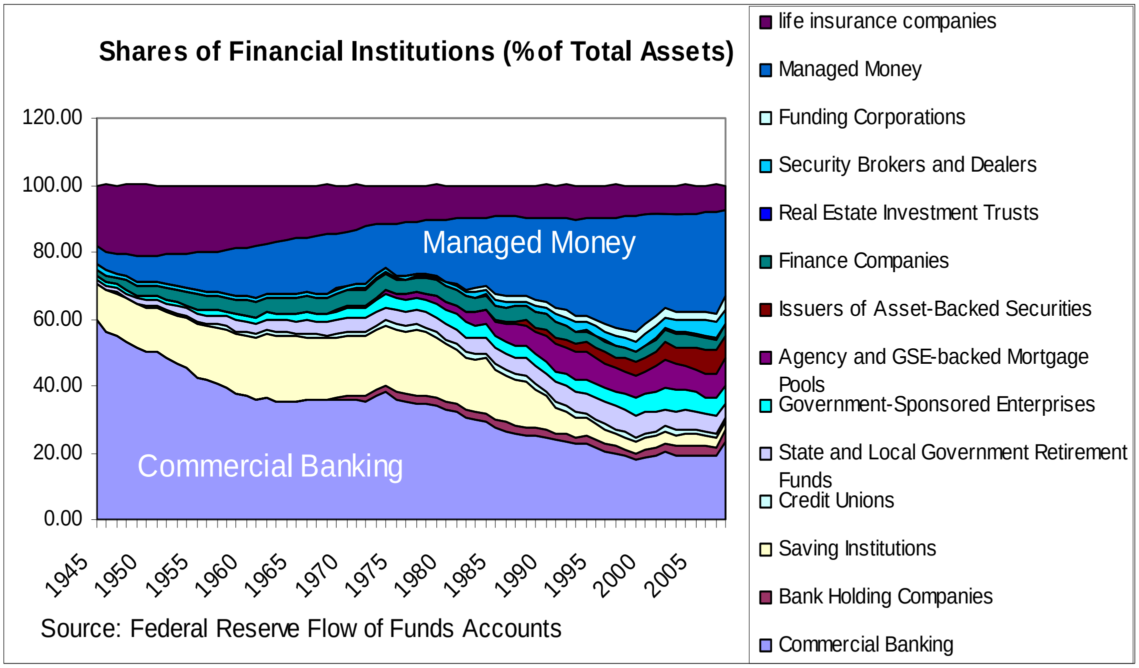
Obviously, pension funds suffer when financial markets crash. It is important to understand, however, that this is a two-way street: pension funds have become so large that they are capable of literally "moving markets". As they flow into a new class of assets, the sheer volume of funds under management will tend to cause prices to rise. Pension funds often follow a strategy through which they will allocate a percent of funds to a particular asset class, and this can occur on a "follow the leader" basis as the popularity of investing in a new asset class increases. This pushes up prices, rewarding the decision. To increase portfolio returns, managers might decide to increase the allocation to well-performing classes of assets. This could contribute to a speculative bubble. Of course, trying to reverse flows—to move out of a class of assets—will cause prices to fall, rapidly.

A good example is the commodities boom, bust, and boomlet that has occurred since the early 2000s. As explained in Wray (2008) the deregulation at the end of the 1990s allowed pension managers to go into commodities for the first time. Previously, pensions could not buy commodities because these are purely speculative bets. There is no return to holding commodities unless their prices rise—indeed, holding them is costly. However, Goldman Sachs (which created one of the two largest indexes) and others promoted investment in commodities as a hedge, on the argument that commodities prices are uncorrelated with equities. In the aftermath of the dot com collapse, that was appealing. In truth, when managed money flows into an asset class that had previously been uncorrelated with other assets, that asset will become correlated. Hence, by marketing commodities indexes as uncorrelated assets, a commodities bubble ensued that would collapse along with everything else. This is because when one asset class collapses—say, securitized mortgages—holders need to come up with cash and collateral to cover losses, which causes them to sell holdings in other asset classes. This is why silver and cattle became correlated when the Hunt Brothers' attempt to corner the silver market failed—they had to sell cows to cover losses on silver.

We will not repeat the analysis in Wray (2008), but in brief, most of the position taken was actually in commodities futures indexes as pension funds decided to allocate, say, 5% of assets under management to commodities. However, there is a close link between index prices and spot prices. While pensions only allocated a small proportion of portfolios to these indexes, this amounted to a huge volume relative to the size of commodities markets. For example, Mike Masters showed that the allocation by pension funds (and other index speculators—with pensions accounting for about 85% of all index speculation) to oil was equivalent to the total growth of Chinese demand for oil for the half decade after 2004. Index and spot prices literally exploded, in what was probably the biggest commodities price bubble ever experienced.

The bubble was also fueled by a policy change: as pension funds poured into commodities and commodity futures, driving up prices of energy, metals, and food and as energy prices rose, Congress mandated biofuels use—which added to pressures on food prices that contributed to starvation around the globe. When pensions started to move out in the late summer and fall of 2008, prices collapsed (they moved about a third of their funds out; oil prices fell from about $150 a barrel to $40). Because other asset classes have performed poorly in recent months, pensions eventually moved back in, and commodities prices regained some ground. While it is too early to tell, it looks like the little boomlet may have come to an end—probably not because pensions have moved out again, but rather because demand for the actual commodities remains sluggish in the face of the global downturn. The point is, however, that pension funds are big enough to destabilize asset prices.

More generally, pension funds are part of what Hyman Minsky called "managed money", and it could be argued that the global financial crisis really resulted from the way that managed money operates. (Wray 2009) Again, this is a huge topic beyond the scope of this Policy Note. But briefly, huge flows of managed money have built up over the postwar period. These seek the highest total return, and in many cases use high leverage ratios to increase return. Innovation plus leverage led to exceedingly risky positions in assets that finally collapsed, beginning in the market for securitized subprime loans. Pensions are just one component of managed money, which also includes hedge funds, sovereign wealth funds, and university endowments. Managed money is a large and growing portion of the financial sector as shown in the following figure (note that public pensions are shown separately):

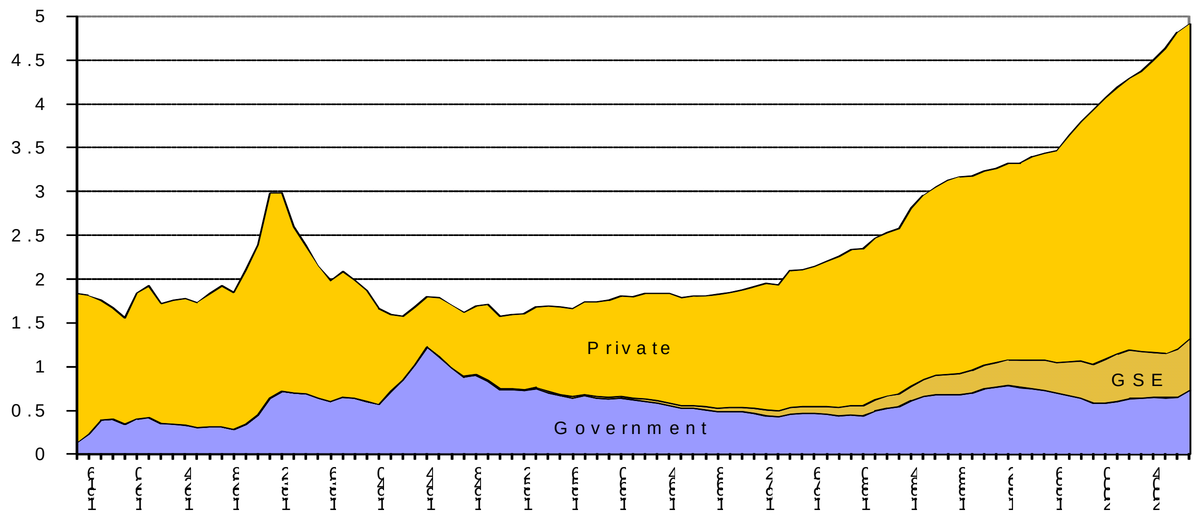


Just before the current global crisis hit, pension funding was, on average, doing well—thanks to the speculative bubble. To restore funding levels, pensions need a new bubble. Indeed, pensions are looking into placing bets on death through the so-called life settlements market (securitized life insurance policies that pay-off when people die early). (Auerback and Wray 2009) Ironically, this would be a sort of doubling down on death of retirees—since early death reduces the amount of time that pensions have to be paid, even as it increases pension fund assets.

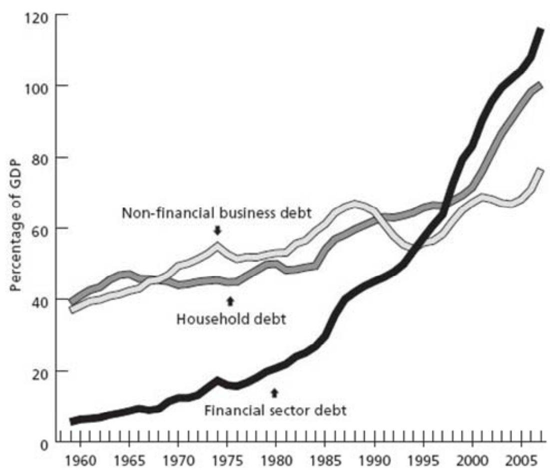
To conclude, pension funds are so large that they will bubble-up any financial market they are allowed to enter—and what goes up must come down. The problem really is that managed money, taken as a whole, is simply too large to be supported by the nation's ability to produce output and income necessary to provide a foundation for the financial assets and debts that exist even in the aftermath of the financial crisis. Hence, returns cannot be obtained by making loans against production (or even income) but rather can be generated only by "financialization"—or layering and leveraging existing levels of production and income. This is why the ratio of financial assets and debts grows continually—and why managed money has to continually innovate new kinds of assets in which to speculate.

The following two graphs are instructive, showing growth of debt that is much faster than growth of GDP:

Financial Liabilities Relative to GDP



Debt as Percent of GDP



Before we conclude this section, it is worth noting the similarities between the US healthcare system and its pension system. Firms also offered healthcare as a tax-advantaged benefit in lieu of wage increases. Over time, this became our current "managed care" system. Like pension funds that are controlled by money managers, our healthcare is managed by highly oligopolized financial firms run by well-compensated executives. In this case, these financial firms are insurance companies. Workers have little control over their healthcare or their pensions that are frequently chosen by employers. Workers are not really “sovereign consumers” in this case because they have neither the knowledge nor usually the ability to shop around for healthcare or pensions—in both cases, employers negotiate with providers and pass fees along to workers. With others in control, there is little to hold down costs—even as wages were sacrificed on the argument that workers were receiving valuable nonwage compensation. Pensions are threatened by underfunding, by the transition to defined contribution, and by a declining proportion of the workforce that is covered. Likewise, the number of workers (and others) without healthcare coverage has been rising, while even those who are covered face exclusions, denial of care in the case of pre-existing conditions, and higher premiums and co-payments. Healthcare “reform” underway in Washington could be seen as a partial answer but at the same time it could be seen as a further financialization of healthcare through mandates that individuals must buy insurance—effectively turning-over more of the national income to financial institutions (in this case, insurance companies).

PENSION FUND STRATEGY

In this section we turn to the strategy followed by pension fund managers. In a nutshell, here is how it works. Each pension fund manager has a strong incentive to meet or beat the average return of pension funds, or face getting fired. Of course, except in Garrison Keilor’s Lake Wobegone, not everyone can be above average—but everyone tries.

There are two fundamental principles widely believed to operate in financial markets: the risk-return relation and the efficient markets hypothesis. Higher risk is rewarded with higher returns, hence, fund managers must take on more risk to get the reward of above-average returns. But since the higher return only rewards higher risk (and thus, losses), with competitive markets the average fund manager will only receive the risk-free return. The higher returns of the brighter or luckier managers will be offset by the lower returns of the dumber and luckless money runners.

With efficient markets, prices reflect all useful information that is worth obtaining. Hence, there really is no reward to skill when it comes to managing pension funds. So it boils down to above average luck. In other words, if your fund manager does not come from the lucky land of Lake Wobegone, pensions would do just as well by investing in riskless Treasury bonds (plus, perhaps, the highest rated state and municipal and corporate bonds--essentially what pensions did in the early period after WWII). Indeed, a simple strategy of buying Treasuries should do better than the average managed pension because hiring an above average fund manager will require above average compensation—so even those funds with B-rated managers would probably provide lower net returns than Treasuries. To be sure, there is some shuffling of the deck so that one manager with a run of good luck can beat the average for a while, but she will probably fail and wipe out several years of winnings in one swoop as some other lucky manager takes her place in the Wall Street lottery. Only the fortunate few can permanently live in Lake Wobegone and thereby beat Treasuries over the long run—and deserve the higher management fees.

To be fair, these two principles may not be entirely correct—or, there could be other forces at play to allow for a positive return to risk even after subtracting losses. If so, that would go against the conventional wisdom that has been driving Wall Street. It does seem plausible that over long periods of time, markets do tend to push risk-adjusted returns toward equality so that on average safe Treasuries will beat net returns on risky assets. There is, however, a positive return to taking illiquid positions. And all things equal, it is probable that longer term maturities (more technically, long duration) receive a premium. Still, when all is said and done, pension managers that follow similar strategies, including taking positions in traded, liquid assets, will push risk spreads toward to the point that they just compensate for losses due to risk and illiquidity.

Each time there is a financial crisis, the funds tank and managers look for strategies to reduce risk. Enter Wall Street sales staff with an array of instruments to hedge and diversify risks. There is one sure bet when it comes to gambling: the house always wins. In financial markets, the financial institutions that create and market complex financial instruments are the house, and they always win—as Das and Bookstaber show. Even if we leave to the side their ability to dupe and defraud pension fund managers, they charge fees for all the instruments they are selling. This ensures that on average pension funds will net less than a risk-free return. But wherever high finance intrudes, sucker bets and fraud usually exist. So the average return should be way below that of Treasuries, and even the lucky managers from Lake Wobegone will probably net less than the risk-free return.

To recap the argument to this point: pension fund managers take on risk on the assumption that with higher risk comes higher return. Financial institutions manufacture risky assets such as securitized subprime mortgages, or even more esoteric CDOs-cubed. It then convinces pension funds that they ought to diversify to reduce risk, for example by gambling on commodities (they have to diversify by law, according to ERISA, that's what kregel was saying and it is there in erisa). By coincidence, Wall Street institutions like Goldman Sachs just happen to be marketing commodities futures indexes to satisfy the demand they have created. It also provides a wide array of complex hedging strategies to shift risk, as well as credit default "insurance" and buy-back assurances in case anything goes wrong.

Ironically, if all of these "risk management" strategies were completely successful, the pension fund would achieve a risk-free portfolio. Of course, it could have achieved this much more directly if it had bypassed Wall Street entirely and gone straight to the Treasury. However, Wall Street would then have had a reduced market for the risky assets and hedges it was pushing, and pension fund managers would not have received their generous compensations for engaging in complex and risky trades. So workers are left with fees that drain their pension funds, and with massive counter-party risk as the hedges, insurance, and assurance go bad.

AN ALTERNATIVE PUBLIC POLICY STRATEGY

As mentioned above, we reward pensions with tax advantages and government guarantees. Before this crisis, as we have shown, private pension fund assets reached about 50% of GDP and state and local government pension fund assets reached almost 25%. So there is a mass of funds equal to three-quarters of the size of national output that owes its existence at least in part to government support. That is a huge industry, and it has created a lot of well-compensated jobs for managers as well as the financial institutions that manufacture and sell the assets purchased.

In a sense, the entire industry can be justified only if through skill or luck pension fund management can beat the average risk-free return on Treasuries by enough to pay all of those industry compensations, plus to add growth to the pension fund portfolio. Yet, the expectation should be that fund managers are significantly less skilled and less "lucky" than, say, the highly compensated employees of the financial institutions they are dealing with. Hence, workers would be far better off if their employers were required to fully fund pensions with investments restricted to Treasury debt. At most, each pension plan would require a very small management staff that would log-on to www.treasurydirect.gov to transfer funds out of the employing firm's bank deposit and into Treasuries, in an amount determined by actuarial tables plus nominal benefits promised. Unlike pricing packaged subprime loans and derivatives, this is not rocket science. Goodbye fund managers and Wall Street sales staff.

Indeed, this raises the question: should the federal government promote and protect pensions at all? Surely individuals should be free to place savings with fund managers of their choice, and each saver can try to find that manager from Lake Wobegone. But it makes no sense to promote a scheme that cannot succeed at the aggregate level—the average fund manager probably cannot beat the average, so on average there is no strong reason to believe that managed funds will provide a net return that is above the return on Treasuries. It would be far better to remove the tax advantages and government guarantees provided to pension plans, and instead allow individuals to put their savings directly into US Treasuries that are automatically government-backed and provide a risk-free return. Perhaps this sort of saving should still enjoy enjoy tax-advantaged status—but we are ambivalent. It is not clear that there is a strong public purpose in promoting private saving—which after all is a deduction from aggregate demand and hence generates a bias toward demand gaps and slow economic growth.

Is there a better alternative that would allow us to provide a safe, secure, and decent living for our retirees?

The US retirement system is supposed to rest on a three-legged stool: pensions, individual savings, and Social Security. Pensions are mostly employer-related and are now seriously underfunded (and the general trend is toward defined contribution plans, which make no promises about the level of retirement benefits or the living standard that will be provided). There are also huge and growing administrative problems posed by the transformation of the US workplace—with the typical worker switching jobs many times over the course of her career, and with the lifespan of the typical firm measured in years rather than decades. This makes the employer-based pension system less suited to current and future realities. And, finally, as discussed here the most plausible long-term net return on managed money would be somewhat below the risk-free return on Treasuries.

The problem with private savings is that Americans do not save enough for their retirement. They never have. That is why government created Social Security, and why unions pushed for pensions. And even if individuals tried to do so, there is no reason to believe that they would do better than pension fund managers. Worse, they could be duped out of their savings by unscrupulous financial institutions selling risky investments.

Thus, the best solution would be to eliminate government support for pension plans and private savings and instead to boost Social Security to ensure that anyone who works long enough to qualify will receive a comfortable retirement. Certainly, individuals are free to supplement this with private savings, according to ability and desires. And employers, unions and employees can continue to negotiate pensions, as desired—but without public subsidies and guarantees.

We anticipate two main objections. First, such a scheme could put a lot of money managers and financial advisors out of business. True. The US financial system is still far too big even after the crisis. In our view, it makes no economic sense to send as much as 40% of corporate profits to the FIRE sector—as we did at the peak of the bubble, and we seem to be restoring the FIRE sector's share even now—as the sector "Hoovers" up a record share of profits again. Second, there is a concerted effort to convince Americans that Social Security is broke, hence, our proposal to ramp up benefits will be met with criticism and perhaps even fear. However, Social Security is a federal government program, and as such it cannot become insolvent. All payments can be made as they come due, even if benefits become more generous. We will not explain here why this is so because there have been a great many Levy Institute publications over the years that provide the details. (See in particular Papadimitriou and Wray 1999)

We close with the hope that some common sense can be brought to bear on the problems facing both private and public pensions. This crisis has brought home the vulnerability that is always just below the surface. And longer term trends that will surely continue mean that even without financial crises, the employment-based pension system is highly problematic. Finally, we have questioned the wisdom of current strategy regarding management of pension funds, arguing that it makes most sense to return to a portfolio of longer maturity and safe financial assets such as US Treasuries. This should provide safety without sacrificing net return—especially if we use Social Security to provide this safe retirement. No accumulation of financial assets will be required to back-up Social Security, since the full faith and credit of the US government stands behind the promised benefits. That is exactly what stands behind US Treasuries—so there is no reason for a ramped up pension plan provided by Social Security to accumulate Treasuries.