Herbert Hoover Pension Rules

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The basic rules of retirement policy are simple. Save early to allow the power of compound interest to ease y
burden. Diversify your investments to reduce your risk. Make steady payments designed to reach your long-t
These rules for individuals also make sense for corporations that bear the burden of providing defined-benefi
pensions. Unfortunately, the government's archaic pension rules prevent companies from following this logic
especially the common-sense idea of steady payments.

During boom times, when profits are high, government rules discourage plan contributions in two important
First, required payments are tied to the market value of the plan. Just as one would expect, this value tends to
in good times, dropping required payments precisely when firms have the ability to make them. Even worse t
the government actually placed an effective limit in 1986 on the amount that firms can contribute each year t
pension plans. It did so by capping tax-deductible contributions and placing an excise tax on nondeductible
contributions. The result was predictable -- firms now keep their pension plans near the minimum funding le
than building up durable cushions. In 1990, 45 percent of defined-benefit plans had a funded ratio of assets to
liabilities of 150 percent. By 1995 only 18 percent of firms maintained such a large cushion.

Just as the government works to discourage contributions during good times, it also forces companies to mak
excessive payments during bad times. These policies have turned a pension problem into a macroeconomic p
that weighs on the economic recovery. First, pension liabilities are discounted using the 30-year Treasury bon
determine whether funding levels are adequate. When the economy weakens, interest rates frequently drop
substantially, raising the present value of pension liabilities. The Treasury Department's decision to no longer
the 30-year bond exacerbated the interest rate decline. This volatility can quickly turn adequately funded plan
seriously unfunded plans. Second, thanks to special procedures enacted in 1994, firms must claw their way b
fully funded plans even more quickly than in past economic downturns.

How big are pension payments becoming? Pension experts estimate that, without a fix, aggregate contributio
2003-05 could run six times higher than in 1999-2001. Such massive payments could lower after-tax corpora
by $65 billion a year, well over 10 percent, battering stock prices. These pro-cyclical payments are the Herbe
Hoover approach to pension funding.

The final problem created by the government is its common law marriage to the Pension Benefit Guarantee
Corporation (PBGC). Although PBGC is funded through industry fees, everyone knows Congress would step
supplemental funds if needed. The perception of an unconstrained PBGC encourages unions and companies t
negotiate excessive retirement packages, even when plans are wildly underfunded, knowing that someone els
on the hook if the plan fails.

The end result of this regulatory bird's nest is a government structure that encourages excessive benefits, prol
prudent funding and requires punitive payments during recessions. No wonder the only way out for some fir
bankruptcy.

Fortunately, lawmakers are beginning to realize the root cause of the pension problem. A consensus is emerg
reduce the pro-cyclical payments over the next two to three years by allowing firms to discount their pension

liabilities with higher-rate corporate bonds.

More is needed however. Legislators should provide temporary relief from the 1994 deficiency payment rule
now that it is clear that this medicine could kill the patient. And they must stop the excessive rise in benefits
occurs at companies with dangerously underfunded plans. The best way to get out of any hole is to stop digg
Proposals in this area must specifically preempt collective bargaining contracts that allow pension benefits to
automatically, even though the plan is underfunded and the company is in trouble. As they address the pro-cy
problems, lawmakers must be careful to avoid simply passing the shortfall on to PBGC and perhaps eventual
taxpayers. Companies should make steady payments that place them on a path to a fully funded plan on an ac
basis.

The Treasury Department has put on the table a creative, though complex, approach that would provide a bet
measure of pension liabilities and hence decrease the possibility of future pension crises. This is a worthy ain
deserving consideration in a comprehensive bill. If Congress gets this critical legislation right, the economic
will accelerate and the next inevitable recession will be a bit less severe.

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